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How product market competition and complexity influence the on-job-learning effect and entrenchment effect of board tenure

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ABSTRACT

The on-job-learning effect implies a positive relationship between firm performance and board tenure. The entrenchment effect implies a negative relationship instead. We document a hump-shaped relationship between board tenure and firm performance. The hump-shaped relationship is eased by competition and complexity. Competition reduces the need of board monitoring while complexity raises the need of board advising leading to the dominance of on-job-learning effect over entrenchment effect and a positive relationship between board tenure and firm performance. The propensity for fraud and stock performance of M & As are non-linearly related to board tenure because of the combination of on-job-learning and entrenchment effects.

1. Introduction

Board of directors provides functions in advising and monitoring (Armstrong, Guaya, & Weber, 2010; Brickley & Zimmerman, 2010; Hillman & Dalziel, 2003). The effectiveness of board advising depends on the professional expertise through directors' accumulating professional knowledge. The longer the board tenure, the more expertise accumulated through on-job-learning (Beasley, 1996; Castro, Dominguez De La Concha, Gravel, & Periñan, 2009; Forbes & Milliken, 1999; Huang, 2013; Kim, Mauldin, & Patro, 2014).

The effectiveness of board monitoring mostly depends on board independence (Vafeas, 2003; Byrd, Cooperman, & Wolfe, 2010). An excessively long serving board is considered entrenched instead independent and neglects the interests of shareholders (Huang, 2013; Hymowitz & Green, 2013). Practitioners even discuss whether it is desirable to restrict board tenure, in order to avoid entrenchment and adverse consequences (Katz & McIntosh, 2014). This paper examines the relationship between board tenure and firm performance and the relationship between board tenure and corporate consequence such as fraud and mergers and acquisitions (M & As) decisions. More importantly, we further examine the roles of product market competition and complexity on the on-job-learning effect and entrenchment effect through board advising and monitoring.

Vafeas (2003) argues that board tenure affects board functions by presenting an expertise hypothesis and a management friendly hypothesis. The expertise hypothesis posits that the directors accumulate their expertise over time to reinforce board advising function. Van Ness, Miesing, and Kang (2010) contend that the longer the board tenure and the more extensive the expertise of the directors. The management friendliness hypothesis states that senior or long-serving boards are friendly to the management, which

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undermines board independence and the monitoring function of the board (Byrd et al., 2010; Niu & Berberich, 2015).

Canavan, Jones, and Potter (2004) suggest that companies with too long board tenure are poor rated. Brunninge, Nordqvist, and Wiklund (2007) show that directors lose monitoring power or independence when they have close relationship with managers through friendship or professional links. Hwang and Kim (2009) indicate that social relationship between CEOs and directors results in high CEO remunerations and low sensitivity to performance. Byrd et al. (2010) indicate that the longer the board tenure, the closer the interactions between directors and CEOs, and the more aligned interests between the board and CEOs. According to Libit and Freier (2015), 74% of institutional investors deem overly long board tenure to be problematic, as it reduces board independence and hamper the entrance of new directors into the board.

Huang (2013) argues a time-varying trade-off between knowledge and entrenchment for board tenure effectiveness and shows that board tenure has an inverted U-shaped relation with firm value. We argue that the relationship between firm performance and board tenure depends on the relative strength of on-job-learning effect and entrenchment effect. The learning curve hypothesis implies that knowledge and expertise accumulation (on-job-learning effect) is a concave function of board tenure. On the contrary, the human relationship accumulation (entrenchment effect) is a convex function of board tenure. Vafeas (2003) and Byrd et al. (2010) argue that the accumulation of interpersonal relationship is more effective over the long term than in the short term. Long tenure board undermines the board independence more dramatically than short tenure board does. Consequently, at a short level of board tenure, on-job-learning effect dominates entrenchment effect. On the contrary, at a long level of tenure, the entrenchment effect dominates the on-job-learning effect leading to a hump-shaped relationship between board tenure and firm performance.

Meanwhile, product market competition and complexity change the on-job-learning effect and entrenchment effect of board tenure. Chen, Kao, and Lu (2014) and Giroud and Mueller (2010) suggest that product market competition reduces agency conflicts and serves as a monitoring or corporate governance mechanism to improve firm performance. Consequently, firms in high competition industries need less board monitoring. Moreover, Coles, Daniel, and Naveen (2008) argue that complex firms need more board advising to deal with the complex operations. If a firm runs highly complex operations and owns significant intangible assets, it takes even longer for its directors to acquire the required expertise (Coles et al., 2008; Huang, 2013).

The relationship between board tenure and firm performance depends on the functions of board advising and monitoring through the on-job-learning effect and the entrenchment effect. Complexity raises the need of board advising while product market competition reduces the need of board monitoring. Therefore, the hump-shaped relationship between board tenure and firm performance disappears for complex firms and/or firms in high competition industries.

We focus on Taiwanese data because Taiwan is characterized as an emerging country with weak investor protection (Klapper & Love, 2004) and a civil law jurisdiction which does not offer strong enough investor protection (La Porta, Lopez-de-Silanes, Shleifer, & Vishny, 2000). Moreover, Claessens, Djankov, and Lang (2000) indicate that in most East Asian countries, including Taiwan, controlling families or controlling groups exist through pyramids or cross-holding. As the majority of managers in Taiwan are family members or group members, they are less likely to be monitored by the board. As such, Taiwanese data contribute to existing literature, as it helps to clarify the relationship between board tenure and firm performance in a weak investor protection economy.

This paper finds a hump-shaped relationship between firm performance and board tenure in general. However, complex firms and firms in high competition industries have a positive relationship between firm performance and board tenure leading to their preference of long tenure directors. Moreover, we show that complex firms prefer more experienced directors because of more advising need while firms in high competition industries have more experienced directors because of less monitoring need.

The remainder of this paper is organized as follows: Section 2 presents the research design and variable definitions. We examine the relationship between firm performance and board tenure in Section 3. Section 4 discusses the relationship between tenure of certain types of directors and firm performance. Robustness tests are provided in Section 5. Finally, Section 6 concludes.

2. Research design

2.1. Data source

Our data comprise the firms listed in Taiwan Stock Exchange over the period 2000–2014. The financial sectors are excluded due to the unique nature of their accounting information. All the variables including board structure variables, M & As, fraud, market equity, book debt, book assets, cash equivalents, fixed assets, book equity, net sales, R & D expenses, advertising expenses, net income, firm age, and weekly stock returns are collected from Taiwan Economic Journal. Finally, we eliminate samples with missing data on the required variables and obtain 11,909 firm-year observations. Table 1 provides the number and percentage of sample per year. The sample size increases over time because more and more firms are listed over time.

2.2. Variable definitions

Our variables consist of firm performance, board tenure, product market competition, complexity, and other control variables. We follow Chen et al. (2014), Kim and Lu (2011) and Morck, Shleifer, and Vishny (1988) to employ Tobin's Q (*Q*) as the firm performance measure, which is defined as market equity plus the book debt, divided by book assets. Board tenure (*TENURE*) is defined as average tenure of non-executive directors on board.[1]

[1] We reach similar results when *ROA* is used as another measure of firm performance or median tenure of directors is used as the measure for board tenure.

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