



# The differential effects of classified boards on firm value



Seoungpil Ahn<sup>a,\*</sup>, Keshab Shrestha<sup>b</sup>

<sup>a</sup> Sogang University, 35 Baekbeom-ro, Mapo-gu, Seoul 121-742, Republic of Korea

<sup>b</sup> Risk Management Institute, National University of Singapore, 21 Heng Mui Keng Terrace, Singapore 119613, Singapore

## ARTICLE INFO

### Article history:

Received 28 July 2010

Accepted 15 July 2013

Available online 20 July 2013

### JEL classification:

G32

G34

K22

### Keywords:

Classified boards

Staggered boards

Corporate governance

Independent directors

Board composition

## ABSTRACT

Classified boards actually benefit firms that have low monitoring costs and greater needs for advisory services. Previous literature has emphasized the entrenchment effect of classified boards. However, we find that this adverse impact of classified boards can be offset or even superseded by the potential benefits of board classification for firms who hope to benefit from the advisory services of their independent directors. We show that firms with greater advising needs appoint more outside directors with diverse attributes and expertise, qualifications that enhance the ability to provide useful advice to managers. Furthermore, in such firms, board classification is associated with higher performance sensitivity of forced CEO turnover and better acquisition performance. Conversely, in firms with high monitoring costs, board classification hurts managerial equity-based incentives and risk-taking incentives. These findings suggest how and through which channels classified boards engender the differential effects on firm value.

© 2013 Elsevier B.V. All rights reserved.

## 1. Introduction

Boards of directors perform two distinct and important functions: they monitor managers and they provide advice to managers.<sup>1</sup> Earlier studies of the impact of corporate governance on firm value have focused exclusively on the monitoring function of boards and concluded that smaller, outsider-dominated boards are most effective at controlling agency problems between managers and shareholders (Weisbach, 1988; Yermack, 1996). More recently, however, several studies explicitly recognize that boards not only monitor managers but also provide advice to managers, suggesting that board structures may optimally vary systematically across firms according to the nature of the firms' assets and the scope and complexity of their operations.<sup>2</sup> These studies predict that optimal board structures are determined by firm-specific characteristics that proxy for monitoring costs and advising needs of firms, implying that when it comes to boards *one size does not fit all*.

While financial economists have extensively studied the influence of monitoring costs and advising needs on certain board

structure, i.e. board size and composition, relatively less attention has been paid to another important dimension of board structure, namely, board classification and its optimality. In this article, we examine whether the impact of board classification on firm value differs across firms according to the nature of the firms' assets and the scope and complexity of their operations. Specifically, by weighing the potential costs and benefits of a classified board structure, we argue that its net effect on firm value is dependent on monitoring costs and advising needs of firms.

A classified board is a board structure that divides the board of directors into separate classes (typically three), with a single class of directors standing for election each year. Unlike unitary boards where directors are elected every year, classified boards allow them to serve for multi-year terms.

A number of past studies support the notion that classified boards entrench managers and thus destroy firm value.<sup>3</sup> We refer to this as the *managerial entrenchment hypothesis*. Focusing on the monitoring function of boards, this hypothesis posits that unitary boards encourage effective monitoring by giving shareholders the opportunity to retain or replace directors each year. Furthermore,

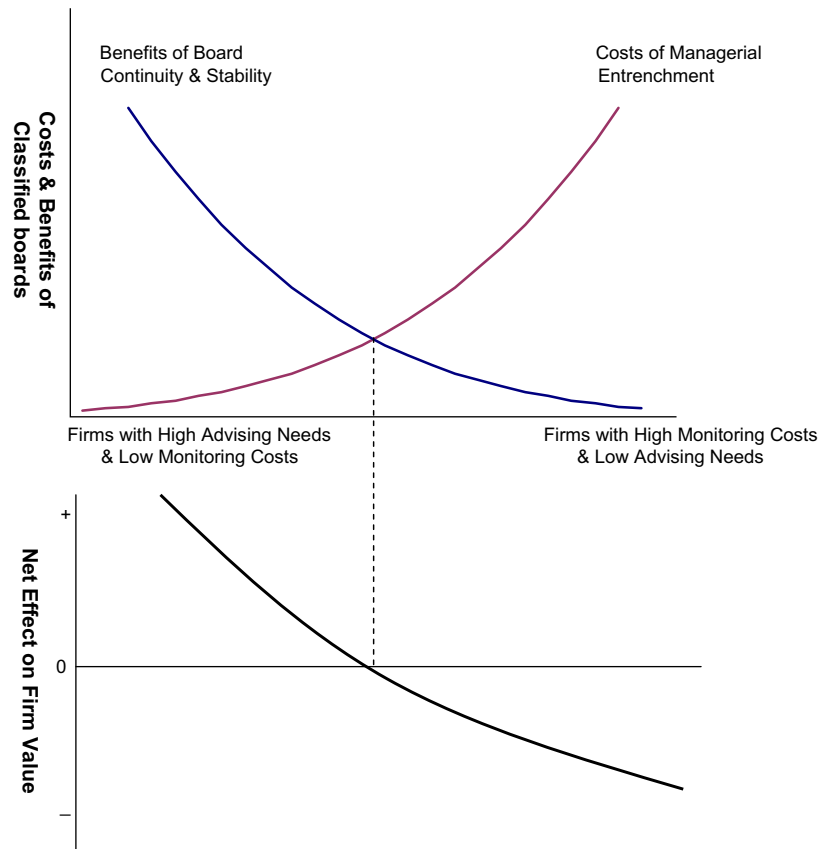
\* Corresponding author. Tel.: +82 2 705 8534; fax: +82 2 705 8519.

E-mail address: [spahn@sogang.ac.kr](mailto:spahn@sogang.ac.kr) (S. Ahn).

<sup>1</sup> Some earlier studies include Fama (1980), Fama and Jensen (1983), and Williamson (1975).

<sup>2</sup> Boone et al. (2007), Coles et al. (2008), Duchin et al. (2010), Harris and Raviv (2008), Lehn et al. (2009), and Raheja (2005).

<sup>3</sup> Recent research that documents a negative relationship between classified boards and Tobin's *q* includes papers by Bebchuk and Cohen (2005), Bebchuk et al. (2009), Faleye (2007), and Gompers et al. (2003). Faleye (2007), for example, estimates that a classified board reduces a typical firm's Tobin's *q* ratio by 13.15%. This is equivalent to a \$795 million reduction in the market value of a typical firm.



**Graph 1.** The costs and benefits of classified boards, monitoring costs, and advising needs, and the net effect of classified boards on firm value.

since a hostile bid is more likely to succeed when poorly performing firms have unitary boards, this external threat provides ex-ante incentives for managers to act in shareholders' interests. By contrast, it is argued that classified boards entrench managers because directors face shareholders' scrutiny only every three years rather than every year. The managerial entrenchment hypothesis, however, seems inconsistent with the fact that a substantial number of large publicly-traded US firms continue to retain classified boards even though classified boards may diminish firm value.<sup>4</sup>

This leads us to an alternative explanation which focuses on the potential benefits of board classification. We refer to this as the *board continuity hypothesis*. This hypothesis contends that board classification promotes board continuity, stability, and director independence, thereby allowing boards to focus on long-term strategic planning. Koppes et al. (1999) and Wilcox (2002) argue that staggered elections encourage board independence by reducing the threat that directors who challenge and disagree with managers will not be re-nominated. Board classification provides directors with a degree of permanence and gives them incentives to invest in firm-specific human capital so that they can give better advice to managers. Thus, one potential benefit of board classification is the ability of directors to advise managers without a fear of retribution. Furthermore, classified boards may facilitate the recruitment process of qualified directors if they dislike going through the annual re-nomination process.

Therefore, considering the potential costs and benefits of classified boards, the net effects on firm value are not necessarily negative for all firms and could even be positive for some firms.

Grounded in the arguments on the determinants of board structure, we expect that the net effects of classified boards are dependent on a firm's monitoring costs and advising needs.

For firms with opaque assets, it is difficult for outside investors to verify growth opportunities and firm-specific information held by insiders and thus monitoring costs are high (Adams and Ferreira, 2007; Duchin et al., 2010; Harris and Raviv, 2008; Hermalin and Weisbach, 1998; Raheja, 2005). While the marginal benefits of intense monitoring are high for these firms, board monitoring tends to be less effective. In such noisy information environments, the lack of shareholders' opportunity to retain or replace directors each year will further deteriorate the efficacy of board monitoring. Thus, for a given amount of private benefits, the entrenchment effect increases with board classification. This suggests that the entrenchment costs of classified boards are higher in firms with high monitoring costs than in firms with low monitoring costs.

A firm's advising needs are associated with the scope and complexity of its operations. Large, old, and diversified firms often need greater advisory services from directors with diverse backgrounds and firm-specific knowledge (Boone et al., 2007; Coles et al., 2008; Klein, 1998). By providing directors with a degree of permanence, independence and incentives to invest in firm-specific human capital, classified boards may enhance the board's ability to provide the required advisory services to managers. Thus, the benefits of classified boards may increase with a firm's need for advisory services.

Weighing the costs and benefits under different environments suggests that the nature of a firm's assets and the scope and complexity of its operations determine the net effect of classified boards on firm value. The previous literature on the effect of classified boards on firm value ignores the influence of monitoring

<sup>4</sup> As of 2006, close to 60% of large public companies had classified boards. Although this figure has fallen of late as many firms have moved towards annual director elections, about half of these large firms retain classified boards.

Download English Version:

<https://daneshyari.com/en/article/5089135>

Download Persian Version:

<https://daneshyari.com/article/5089135>

[Daneshyari.com](https://daneshyari.com)