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Busy directors and firm performance: Does firm location matter?[☆]

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ABSTRACT

We examine whether busy directors' impacts on firm performance vary with firm headquarter locations. We classify firms into Metro and Rural firms based on their headquarter locations. Using a sample of 11,537 firm-year observations from 1997 to 2013, we find that Metro firm busy directors significantly enhance firm performance and are associated with lower default risk, lower cash effective tax rate, lower real earnings management, and more efficient assets utilization. We further show busy independent directors enhance firm performance after the 2007–2008 financial crisis, but not in the early years after SOX. Interestingly, the results indicate that SOX compromises the effectiveness of busy inside directors in Metro firms in the post-SOX period. The location effect is robust across multiple model specifications and various measures of director busyness and Metro firms. We conclude that firm location affects the effectiveness of busy directors and Metro firms benefit more from directors with multiple directorships.

1. Introduction

Busy directors, defined as those with three or more outside directorships[1] (Ferris, Jagannathan, & Pritchard, 2003; Fich & Shivdasani, 2006; Jiraporn, Kim, and Davidson, 2008), affect firm performance. Empirical studies document equivocal results on the impact of busy directors on firm performance, with some studies show a positive effect (Ferris et al., 2003; Fich, 2005; Field, Lowry, & Mkrtchyan, 2013; Harris & Shimizu, 2004; Keys & Li, 2005), while others document a negative one (Ahn, Jiraporn, & Kim, 2010a,2010b; Andres & Lehmann, 2010; Jiraporn, Kim, & Davidson, 2008). Cashman, Gillan, and Jun (2012) contribute the disparate results to sample selection and empirical design. We argue that contextual factors may also lead to these inconsistent findings.

Studies show that busy directors are not universally the same.[2] Further, specific contextual factors, such as firm characteristics, firm operating environment, director incentives, directors' perception of the importance of a directorship, may affect their social and professional connections, behavior, decisions, value creation abilities, and hence firm performance. Therefore, simply counting the

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[1] We use different definitions of busy directors in Robustness check, specifically, we use both 2 and 4 directorships as cutting-off points to classify whether a director is busy or not.

[2] For example, Benson, Davidson, James, and Wang (2017) show busy inside directors are more likely to use share repurchases and tend to repurchase more, while busy independent directors prefer dividends and tend to pay higher levels of dividends. Benson, Davidson, Davidson, and Wang (2015) document that busy CEOs in bidder firms pay lower premiums in mergers and acquisitions, while target busy CEOs shirk their responsibilities by accepting lower premiums.

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number of outside directorships held by individual directors and/or focusing on their affiliations to the host firms may not be able to capture their true value effects. For example, Field et al. (2013) find busy directors in IPO firms have different value effects from those in the most established firms; Elyasiani and Zhang (2015) show that the performance of bank holding companies increases with director busyness; Masulis and Mobbs (2014) show that busy directors rank directorships held and allocate their limited resources unequally by distributing more efforts and resources to firms where their directorships are more prestigious or are perceived more valuable. Therefore, we cannot generalize the effect of busy directors on firm value.

In this paper, we analyze the effect of a firm's location on busy director-firm performance relation. We classify firms into Metro firms and Rural firms based on their headquarter locations. Metro firms refer to those located in one of the largest ten metropolitan statistical areas (MSA areas) as of the 2010 Census (Loughran, 2008; Gao, Ng, & Wang, 2011; John, Knyazeva, & Knyazeva, 2011).[3] Rural firms are those that do not satisfy the definition of Metro firms. We empirically test whether Metro firms benefit more from busy directors than Rural firms and investigate possible channels through which value is created by busy directors. We further examine whether busy directors-firm performance relation varies corresponding to two important events in recent history: the Sarbanes-Oxley Act (SOX) of 2002 and the 2007–2008 financial crisis, since the two events triggered significant debates on the effectiveness of board monitoring and its impact on firm value. In particular, we use Tobin's Q and return on assets (ROA) as firm performance proxies. Tobin's Q is calculated as the market value of common equity plus the book value of assets minus the book value of common equity scaled by the book value of assets and ROA is calculated as the ratio of earnings before interest and taxes to total assets.

Using a sample of 11,537 firm-year observations from 1997 to 2013, we find that Metro firm busy directors significantly enhance firm performance. The parameter estimates suggest that one percentage increase in the proportion of busy inside/independent directors increases Tobin's Q by 0.13/0.04 percentage. In addition, Metro firm busy directors are associated with lower default risk, lower cash effective tax rate, lower real earnings management, and higher assets utilization efficiency. Metro firm busy directors' favorable financial strategies provide some explanations on the positive relation between busy directors and overall performance in Metro firms. Further analysis shows Metro firm busy independent directors have a stronger positive effect on firm performance in the post-financial crisis years (2008–2013), but not in the immediate post-SOX period (2003–2007). In addition, SOX may have some unintended effects on inside directors as the results show that Metro firm busy inside directors' role in value creation is compromised in the post-SOX period.

The location effect on the director busyness-performance relation is robust across various model specifications and different definitions of key variables. First, we control the potential endogeneity between firm performance and busy directors, induced by either unobservable omitted variables and/or the selection of busy directors by better performing firms, with instrumental variable approach and firm fixed effect regressions. Second, we mitigate sample selection bias with Heckman selection model and address the issue of observable omitted variable bias by adding more control variables. Third, we conduct a Chow test to directly examine the structural changes between firm performance and director busyness around SOX. Lastly, we use different definitions and measurements of firm performance, director busyness, and Metro firms. Our major findings remain with all the tests.

We enrich the existing literature on director busyness and firm geographic location in various ways. First, we are the first to address the role of location in the effectiveness of busy directors. The location effects provide some explanations on the controversial evidence of the busy director-firm performance relation. Second, we complement the current literature on the non-universal role of busy directors and the results have some policy implications. The findings that Metro firm busy directors improve firm performance suggest that limiting the number of directorships held by a director may not always be in the best interest of shareholders. Third, the results imply the priority of Metro firm busy directors, reflecting that directorships carry different values and provide different incentives to their holders. Finally, not only do we document a positive relation between Metro firm busy directors and firm performance, but also explore and identify some channels through which Metro firm busy directors create value.

We organize the remainder of this paper as follows. In Section 2, we motivate our research, review the literature, and develop our hypotheses. We provide an overview of our sample and the data in Section 3. In Section 4, we present our empirical results and provide concluding remarks in Section 5.

2. Literature review and hypothesis development

2.1. Firm location and corporate decisions

Firms exercise caution in selecting their headquarters' and subsidiaries' locations to take advantage of various location benefits and fulfill their objectives. For example, Yamori (1998) notes that financial institutions choose their locations based on FDI (foreign direct investment) manufactory industries and local banking opportunities in host countries. According to Dyreng, Lindsey, and Thornock (2013), U.S. firms locate subsidiaries in Delaware for tax benefits and a Delaware-based state tax avoidance strategy lowers state effective tax rates by 0.7% to 1.1% which effectively reduces a firm's tax burden and increases its earnings.

The relevance of geography in corporate decisions and valuation has been extensively documented. Gao, Ng, and Wang (2008) indicate that a firm's geographic dispersion affects its policies and has important implications on its valuation. Studies show that a firm's location affects its cost of capital (Arena & Dewally, 2012; Boubakri, Guedhami, & Saffar, 2016; Husted, Jamali, & Saffar, 2016), equity issuance (Loughran, 2008), likelihood of financial misconduct (Kedia & Rajgopal, 2011), capital structure (Gao et al., 2011), dividend policy (John et al., 2011; Ucar, 2016)[4] broad based option plans (Kedia & Rajgopal, 2009), stock price crash risk

[3] In the robustness test, we use the distance to major airports defined by Federal Aviation Association (FAA) to define Metro and Rural firms.