

Does director tenure affect audit committee effectiveness?

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ABSTRACT

This study examines whether director tenure increases or decreases audit committee effectiveness. The issue is a timely one as long-tenured directors are becoming increasingly common, raising concerns that excessive familiarity with management will impair director independence. Consistent with prior research, discretionary accruals are used as a measure of earnings management. The results show that earnings management is negatively associated with the proportion of long-tenured directors serving on the audit committee. Further analysis demonstrates that the presence of even one long-tenured director on the audit committee reduces earnings management. Rather than impairing independence, lengthy tenure appears to give directors experience and insights that allow them to more effectively serve shareholder interests.

Keywords: director tenure, corporate governance, audit committee, earnings management



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INTRODUCTION

How long is too long for a director to serve on a corporate board? Increases in the length of director tenure have drawn the attention of both the academic and popular press. Long-tenured directors are becoming routine, with Frances and Lublin (2016) reporting that one-third of S&P 500 directors have served on their boards for at least 10 years. They also note that nearly one-quarter of S&P 500 companies have a majority of board members with more than 10 years of tenure.

At issue is whether such an extended period of service compromises a director's ability to monitor management actions and represent stockholders. No consensus has emerged. As Jia (2015) notes, ". . . existing academic studies on this issue are sparse and offer conflicting results" (p. 1). Frances and Lublin (2016) summarize the contrasting perspectives:

"Long-tenured directors can offer companies institutional memory and deep insight into company operations across a variety of economic and competitive environments – as well as, potentially, the experience to question even longtime managers. Yet some investors worry that longtime board members may grow too close to the companies and management teams they are supposed to oversee, and lack the critical eye and fresh ideas that newer directors bring."

This study examines the effects of tenure on director effectiveness by focusing on corporate audit committees. Given the critical role of the audit committee in monitoring the financial reporting process, anything with the potential to compromise the effectiveness or independence of audit committee members merits investigation. Additionally, most of the few prior studies into this issue have used data drawn all or in part from before enactment of the Sarbanes-Oxley Act of 2002 (SOX). The timing is important because SOX redefined the role of a corporate audit committee. As Sharma and Iselin (2012) note:

Directors' workload has significantly increased in the post-SOX environment because of the greater oversight responsibilities of the audit committee. Audit committees are required to be more diligent and scrutinize management and corporate activities, such as the internal audit function, internal controls, financial reporting issues, audit selection, determination of audit and nonaudit fees, evaluating auditor independence, and dealing with whistle-blower. Accordingly, audit committees are under heightened scrutiny from regulators, analysts, institutional investors, and other capital market participants (p. 154).

The dramatic changes in corporate governance and audit committee responsibilities created by SOX make the issue of director tenure and effectiveness one deserving of further inquiry.

The remainder of the paper is divided into four sections. The first section summarizes the relevant literature regarding director tenure. The sample selection and research method are discussed in the second section, followed by presentation of the results. The paper closes with a summary and discussion of the findings.

DIRECTOR TENURE

Vafeas (2003) provided two opposing hypotheses regarding the effect of tenure on director effectiveness. The “expertise hypothesis” posits that the increased knowledge of the firm resulting from longer director tenure will lead to greater levels of experience, competence, and commitment. In contrast, what he termed the “management friendliness” hypothesis holds that long serving directors are less likely to objectively monitor and more likely to befriend corporation management.

The non-academic business community, while acknowledging the existence of these differing perspectives, has generally come down in favor of the “management friendliness” hypothesis and of limits to director tenure. For example, the California Public Employees’ Retirement System (CalPERS 2016) recently revised its guidelines to call for companies to scrutinize the independence of any director with more than 12 years of service. Further evidence of this skepticism of long-tenured directors is provided by Canavan, Jones, and Potter (2004), who state that “. . . all the major rating agencies other than Institutional Shareholder Services (ISS) include some sort of board tenure as one of their criteria for evaluating board effectiveness, with longer tenure potentially leading to lower scores” (p. 39). It should be noted that the ISS Proxy Voting Guidelines do now also include director tenure as a criterion, calling for scrutiny of “boards where the average tenure of all directors exceeds 15 years for independence from management and for sufficient turnover to ensure that new perspectives are being added to the board” (ISS 2016, p. 19).

Academic research into the issue of director tenure has yielded mixed results. Vafeas (2003) examined a sample of publicly traded firms and found that companies with long-tenured directors serving as members of the compensation committee paid their CEO’s significantly higher salaries than did other firms. His results support the management friendliness hypothesis, leading to his conclusion that:

Senior directors compromise shareholder interests by inflating CEO salaries. The presence of directors with twenty or more years of service on the board appears to be a sign of CEO entrenchment (p. 1062).

Dou, Sahgal and Zhang (2015) reported opposite results in their examination of the same issue. They found that boards with a higher proportion of long-tenured directors were associated with lower CEO compensation. Boards with higher proportions of long-term directors were also less likely to restate earnings. They concluded that “experienced directors provide a balance of power in the boardroom” (p. 31).

Jia (2015) analyzed the effects of director tenure through the perspective of corporate innovation. Both innovation productivity (as measured by the number of successful patent applications filed in a year) and innovation quality (as measured by the number of citations received by each patent in later years) were examined. Jia (2015) found a negative correlation between boards with higher percentages of long-tenured directors and innovation productivity and quality.

Huang (2013) investigated the relation between director tenure and firm value. He found that a firm’s value increased as the average tenure of its directors increased, but only up to a point. After an average tenure of approximately nine years, firm value began to decrease with further increases in director tenure. He noted, for example, that “for an average board tenure of

15 years, adding one year to board tenure decreases firm value by an average of 0.52%” (Huang 2013, p. 12).

Berberich and Niu (2011) adopted corporate governance as their framework through which to analyze the effects of director tenure. Using average years of service as a measure of director tenure, their examination of a sample of S&P 1500 firms showed that long-tenured directors were more likely to encounter corporate governance problems than were directors with shorter terms of service.

Few academic studies have focused specifically on the effects of director tenure on the effectiveness of the audit committee, as opposed to the board of directors as a whole. Bedard, Chtourou, and Courteau (2004) evaluated various audit committee characteristics associated with the audit committee’s ability to constrain earnings management. Using data from 1996 and employing discretionary accruals as a measure of earnings management, they found some evidence that the average tenure of audit committee members was negatively related to aggressive earnings management. They concluded that “knowledge of the company’s operations and of its executive directors acquired through experience as a member of the board seems to be effective in constraining aggressive earnings management . . .” (p. 29).

These findings were consistent with those reported by Liu and Sun (2010). Employing discretionary accruals as a measure of earnings management and data from 1998 - 2005, they found evidence that earnings management was negatively associated with the proportion of long-tenured directors on the audit committee. This reduction in discretionary accruals was taken as evidence of increased audit committee effectiveness.

Sharma and Iselin (2012) employed a different measure of audit committee effectiveness and reached a different conclusion. Their examination of audit committee member characteristics and financial misstatements in the post-Sarbanes-Oxley era found a positive association between audit committee tenure and misstatements. Their findings “suggest that independent directors with an enduring association with management compromise the effectiveness of their oversight responsibilities” (p. 172).

Interpreting the two studies using discretionary accruals as a measure of audit committee effectiveness is made more difficult by the fact that all or part of the data used in their analyses predates enactment of the Sarbanes-Oxley Act of 2002. Bedard et al. (2004) analyzed firm data from the pre-SOX year of 1996. Liu and Sun (2010)’s sample included data from 1998-2005, a period straddling the effective date of the SOX provisions. This study provides insight into the effects of director tenure on an audit committee’s ability to effectively operate in the post-SOX environment.

RESEARCH DESIGN

Sample selection

First, 100 firms were randomly selected from the S&P 500 Index. To ensure a broad cross-section of sample firms, another random sample of 100 companies was drawn from the Russell Microcap Index, which consists of 2,000 of the smallest publicly held companies in the country. The resulting sample of 200 companies thus represents the both largest and smallest public firms in the United States.

Proxy statements from 2015 were examined for each sample firm using the SEC’s EDGAR database. Information about directors and board governance were taken from the proxy

statements. Financial statement information for each firm was obtained from the S&P Research Insight database as well as company Form 10-Ks filed with the SEC. Data, including length of service on the board, were obtained for 1,841 corporate directors. Table 1 (Appendix) provides selected descriptive information about the sample.

As Table 1 indicates, extended service on boards of directors is common. The average board tenure for the sample as a whole was 9.04 years. Directors serving on the audit committee had a slightly shorter average tenure of 8.38 years, despite being slightly older than directors as a whole (63.04 years vs. 61.98 years). Approximately one third of directors had been on their boards for more than 10 years, with 57 years the longest tenure period observed.

Model and Variables

Following Bedard et al. (2004) and Liu and Sun (2010), discretionary accruals are used as a measure of earnings management. Lower discretionary accruals are thus considered as consistent with audit committee effectiveness. The model for discretionary accruals is:

$$ACC/TA_{t-1} = a_0 1/TA_{t-1} + a_1 \Delta SALES/TA_{t-1} + a_2 PPE/TA_{t-1} + \varepsilon$$

Where

ACC	= total accruals measured as the difference between cash from operating activities and income before extraordinary items,
TA _{t-1}	= total assets at the beginning of the year,
ΔSALES	= change in sales from prior year to current year,
PPE	= property plant and equipment.

The parameters for the model were estimated for the sample as a whole. The residual values from this model were then employed as estimates of discretionary accruals. Since earnings management can both raise and lower earnings, consistent with Bedard et al. (2004) and Liu and Sun (2010), the absolute value of discretionary accruals was used in the analysis.

The impact of director tenure on audit committee effectiveness was then tested using the following regression model, adapted from that employed by Liu and Sun (2010).

$$EFFECTIVE = fn(ACSIZE, IND\%, MB, DEBT, SIZE, LOSS, TENURE)$$

where:

EFFECTIVE	= the absolute value of discretionary accruals,
ACSIZE	= the number of directors serving on the audit committee,
IND%	= the proportion of board members classified as independent,
MB	= the ratio of the market value of common equity to the book value of the common equity,
DEBT	= the ratio of debt to total assets,
SIZE	= the natural log of total assets,
LOSS	= 1 if the firm reported a loss in the most recent year, 0 otherwise,
TENURE	= the proportion of audit committee members with more than 10 years of service as a director.

The independent variables are drawn from prior research. Ghosh, Marra, and Moon (2010) found that firms with larger audit committees (ACSIZE) were less prone to earnings management. Elshandidy and Hassanein (2014) summarize studies indicating that independent directors (IND%) are more effective monitors of management's opportunistic behavior, thus potentially limiting discretionary accruals. The market value-book value ratio (MB) serves as a proxy for firm growth opportunities and has been linked to the incentive to manage earnings by Skinner and Sloan (2002). Klein (2002) summarizes research linking DEBT and negative net income (LOSS) to earnings management and discretionary accruals. Discretionary accruals have also been shown to be associated with firm size (SIZE), as noted by Krishnan (2003). TENURE, the proportion of audit committee members with more than 10 years of service as a director, is the primary independent variable of interest.

RESULTS

Table 2 (Appendix) presents information about the independent regression variables. The average size of the audit committee (ACSIZE) is 3.94, with nearly one-third of members having more than 10 years of board tenure (TENURE = 0.31). No correlations between the independent variables appear excessive, with the maximum absolute value among the Pearson correlation coefficients is 0.518, between LOSS and SIZE.

Regression results are presented in Table 3 (Appendix). The model as a whole is significant ($F = 6.271$, $p < 0.001$). The highest variance inflation factor (VIF) observed is 1.762, reducing concerns about multicollinearity. The coefficient for SIZE is negative and significant, while the coefficient for LOSS is positive and significant. Thus, earnings management appears to be less of an issue with larger firms, but more of a concern for firms with negative earnings.

The independent variable of primary interest is TENURE. The coefficient for TENURE is both negative and significant ($p = 0.003$), providing support for the view that the increased experience provided by long service as a director is effective in constraining earnings management.

Further Analysis

The variable TENURE has been defined as the proportion of audit committee members with more than 10 years of service. However, given the small size of corporate audit committees, it is possible that the presence of even one director with extensive experience may be able to influence the committee to effectively constrain earnings management.

To investigate this possibility, the regression model was re-estimated with a different measure of director tenure. TENURE2 is defined as an indicator variable, set to one if any member of the audit committee has more than 10 years of service, zero otherwise. The other variables in the model remain as previously defined. Results of this re-estimation are presented in Table 4 (Appendix).

As Table 4 shows, the coefficient for TENURE2 is negative and significant ($p = 0.002$). These results indicate that, in the context of a small group such as an audit committee, the presence of even one director with substantial experience can significantly limit earnings management. Taken together, Tables 3 and 4 provide evidence that long-tenured directors can significantly increase audit committee effectiveness.

CONCLUSION

This study examines whether director tenure affects the effectiveness of the audit committee, an issue of heightened interest in recent years as the length of director service has increased (Francis and Lublin 2016). Two contrasting perspectives provide the framework for debate on this issue. What Vafeas (2003) has termed the “expertise hypothesis” holds that directors serving for long periods of time acquire extensive knowledge about the firm and are thus able to more effectively serve shareholder interests. The “management friendliness” hypothesis, on the other hand, posits that long serving directors risk losing their objectivity and become more likely to befriend corporation management than to represent shareholders.

Prior research into this issue has been limited, little of it using data exclusively from after the enactment of the Sarbanes-Oxley Act of 2002. This study provides evidence regarding tenure and effectiveness in the context of the greatly expanded audit committee responsibilities in the post-SOX era.

Employing a sample comprised of both large and small publicly held firms, a regression model was estimated using discretionary accruals as a measure of earnings management. A negative association between tenure and discretionary accruals could be taken as evidence of effectiveness in the audit committee’s monitoring of management behavior. This study documents such an association, as the proportion of audit committee members with more than 10 years of service is significantly and negatively associated with discretionary accruals. Further analysis revealed that the presence of even one audit committee member with more than 10 years of experience was significantly associated with lower accruals and increased effectiveness.

The results of this study strongly support the “expertise hypothesis,” suggesting that long-tenured directors gain experience and knowledge from their service that, in turn, increases their effectiveness. These findings argue against the “management friendliness” hypothesis and against efforts to limit director tenure.

Jia (2015) noted that research into the issue of director tenure has been “sparse.” By itself this study does not alter that observation and additional research is clearly warranted. One possible avenue of inquiry might be to investigate the nature of the knowledge and expertise that long experience as a director provides. Are such gains to experience constant across industries or are there some industries where experience and knowledge play an especially important role in enhancing director effectiveness?

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APPENDIX

Table 1
Director Tenure – Descriptive Information

	<u>Board of Directors</u>	<u>%</u>	<u>Audit Committee</u>	<u>%</u>
# of Directors	1,841		787	
Age – Average	61.98 years		63.04 years	
Age - Maximum	91 years		89 years	
Board Tenure - Average	9.04 years		8.38 years	
Board Tenure - Maximum	57 years		39 years	
# with < 5 years tenure	721	39.16%	305	38.75%
# with 6–10 years tenure	497	27.00%	232	29.48%
# with 11-15 years tenure	324	17.60%	149	18.93%
# with 16-20 years tenure	152	8.26%	59	7.50%
# with > 20 years tenure	147	7.98%	42	5.34%

Table 2
Independent Variable Means and Pearson Correlations

<u>Variable (mean)</u>	<u>IND%</u>	<u>MB</u>	<u>DEBT</u>	<u>SIZE</u>	<u>LOSS</u>	<u>TENURE</u>
ACSIZE (3.94)	0.441***	0.106	-0.054	0.498***	-0.295***	-0.015
IND% (0.82)		-0.013	-0.028	0.355***	-0.080	-0.119
MB (12.93)			0.003	0.052	-0.059	0.107
DEBT (0.75)				0.013	-0.040	0.092
SIZE (7.73)					-0.518***	0.107
LOSS (0.21)						-0.192***
TENURE (0.31)						1.000

Table 3
Regression Results

EFFECTIVE = fn(ACSIZE, IND%, MB, DEBT, SIZE, LOSS, TENURE)

<u>Variable</u>	<u>Estimate</u>	<u>t-statistic</u>	<u>Pr> t </u>
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Intercept	0.241	3.010	0.003
ACSIZE	-0.005	-0.513	0.609
IND%	-0.062	-0.587	0.558
MB	-0.000	-0.008	0.994
DEBT	0.000	0.276	0.783
SIZE	-0.011	-2.210	0.028
LOSS	0.065	2.466	0.015
TENURE	-0.092	-2.628	0.009
Adj R-square	0.158		
F-statistic	6.271		
Pr > F	<0.001		
Highest VIF	1.762		

Table 4
Regression Results – Re-estimated Model
EFFECTIVE = fn(ACSIZE, IND%,MB,DEBT,SIZE,LOSS,TENURE2)

<u>Variable</u>	<u>Estimate</u>	<u>t-statistic</u>	<u>Pr> t </u>
Intercept	0.227	2.920	0.004
ACSIZE	-0.000	-0.039	0.969
IND%	-0.053	-0.510	0.611
MB	-0.000	-0.238	0.812
DEBT	0.000	0.217	0.829
SIZE	-0.010	-2.073	0.039
LOSS	0.067	2.567	0.011
TENURE2	-0.066	-3.171	0.002
Adj R-square	0.171		
F-statistic	6.805		
Pr > F	<0.001		
Highest VIF	1.773		