MULTIPLE BOARD APPOINTMENTS: ARE DIRECTORS EFFECTIVE?

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Abstract

Our paper examines the relationship between the presence of interlocked directors on a board and earnings quality. For a sample of 554 firm-years spanning 2003 to 2004, we find that the presence of interlocked directors on board is associated with higher earnings quality as measured by the accrual quality model. It shows that the presence of interlocked directors on a board provides an incentive for diligent monitoring as they have the knowledge, expertise, skill and stronger incentive to actively monitor the actions of management and improve the quality of financial reporting. The relation, however, appears non-linear. Too many members in a firm with interlocking directorates appear to deteriorate the quality of earnings. Our results underscore the importance of the corporate governance recommendations of limiting the number of directorships held by any one individual as a means of strengthening the monitoring and oversight role that the board of directors play in the financial reporting process.

Keywords: Corporate governance, director interlocks, earnings quality, Malaysia.

1. Introduction

The board of directors' role as a monitoring tool is viewed as the most crucial element for effective corporate governance mechanisms to enhance the quality and integrity of accounting information. While creating a board that is effective in monitoring management actions is dependent on the composition of individuals who serve on the board of directors (i.e. executive directors and non-executive directors), another feature of the board which has recently acquired a great deal of interest is directors' interlocks[1]. Fama and Jensen (1983) contend that interlocking directorates can signal director quality. Interlocking directorates help directors be more transparent in making decisions as they can make comparisons based on knowledge of the best board practices gained from other firms (Haniffa and Cooke, 2002). Service on multiple boards create a strong incentive for the directors to perform their duties well (Vafeas, 2005) and provide them with a greater diversity of experience (Ferris *et al.*, 2003; Harris and Shimizu, 2004). Nevertheless, interlocking directorates to some extent has become a controversial topic. The National Association of Corporate Directors guidelines (NACD) recommend for senior corporate executives and CEOs should hold not more than three outside directorships (Jiraporn *et al.*, 2009b).

More strictly, the Council of Institutional Investors recommends directors with full-time jobs to serve not more than two other boards (Ferris *et al.*, 2003). The Australian Shareholders' Association (ASA) claims that any director who sits on more than five boards is actually doing a disservice to the companies' shareholders (Kiel and Nicholson, 2006). In Malaysia, the Bursa Malaysia Listing Requirements is more lenient, permitting a director to hold up to twenty five directorships at one time, of which ten directorships are in public listed companies and fifteen directorships in unlisted companies (Abdul Rahman, 2006). Despite this controversy, very little research has been undertaken concerning the effect of interlocking directorates on financial reporting quality, specifically from a developing country such as Malaysia. Our paper extends the literature on board composition by providing an examination of whether the presence of interlocked directors on board is associated with the quality of reported earnings. Specifically, we examine whether the presence of interlocked directors is associated with higher earnings quality.

[1] Directorship interlocks occur when a person from one organisation sits on the board of directors of another firm (Phan *et al.*, 2003).

Given a scarcity of qualified independent directors in Asian corporations (Barton *et al.*, 2004), little is known about the degree to which interlocking directorates contributes to a board's governing effectiveness in an Asian environment which requires further empirical investigation. The empirical evidence suggests that the presence of interlocked directors on board is associated with higher earnings quality. The relation, however, is non-linear and negative up to a certain point. In other words, the presence of interlocked directors on board is likely to be associated with higher earnings quality as long as the proportion of directors on the board with directorships in other companies to the total number of directors does not exceed certain value. Beyond that value, too many directors on board with interlocking directorates appear to deteriorate earnings quality. We organise this study into five sections. Section 2 discusses the relevant literature to develop research hypotheses. Section 3 outlines and explains the sample selection, research method and variable measurement. Section 4 analyses and discusses the research results. Finally, the conclusions are considered in Section 5.

2. Literature review and hypotheses development

The debate on the costs and benefits of directorship interlocks continues among researchers. Haniffa and Hudaib (2006) suggest that the benefits from interlocking directorates come from two different motives – information exchange motive and control motive. Under the information exchange motive, the interlocking directorates serve as an influential source of information relating to new policies, trade secrets and practices among firms. Interlocking directorates allow the directors to be exposed to recent economic trends; international business; different management styles; monitoring behaviour; and different management policy and practices. Under control motive, interlocking directorates serve as a mechanism for control and offers additional insights into the outcomes of other companies, facilitating comparisons as well as enhancing control (Haniffa and Hudaib, 2006). Nonetheless, institutional investors and shareholder activists claim that directorship interlocks reduce the effectiveness of monitoring activities (Ferris *et al.*, 2003). As the directors serve on several boards, it has been suggested that they may not be able to understand each business well enough to be effective in performing their jobs (Bathala and Rao, 1995). Prior studies suggest that board with more interlocked directors could indicate weak governance either because directors' independence is jeopardised (Phan *et al.*, 2003; Jiraporn *et al.*, 2009b) or because board members are simply too busy to perform their monitoring role effectively (Ferris *et al.*, 2003; Harris and Shimizu, 2004; Jiraporn *et al.*, 2009a,b).

It is argued that serving on multiple boards threaten available preparation time for board meetings thus limit directors' ability to provide useful advice (Harris and Shimizu, 2004). Related research shows that directorships interlocks impact corporate reporting. Ferris *et al.* (2003) find that firm performance has a positive effect on the number of appointments held by a director. Their observations further suggest that directors who serve larger firms and sit on larger boards are more likely to attract additional directorships. Harris and Shimizu (2004) document that overboarded directors may be an asset to the company due to their expert advice and efficient decision making upon their experiences from other boards. Similarly, Stuart and Yim (2010) report economically significant effect of having interlocked directors with experience in private equity transactions. A study by Bedard *et al.* (2004) and Norman *et al.* (2005) finds that the greater the additional number of other directorships held by board members is associated with the lower the likelihood of earnings management activity of the firm. Norman *et al.* (2005) suggest that multiple directorships serve as important governance mechanisms in mitigating earnings management activity and any attempt of earnings management would jeopardize directors' future in the managerial labour market.

Although the study by Haniffa and Cooke (2002) failed to find a significant relationship between multiple directorships and the level of disclosure in Malaysia, their recent study on issues relating to corporate social reporting reveals a significant relationship between chairmen with multiple directorships and corporate social reporting disclosure. This indicates that cross-directorships held by the chairmen does have important positive implications for corporate social disclosure practices as they are able to obtain greater access to information in more than one company, thus ensuring the consistency of voluntary information between companies they service (Haniffa and Cooke, 2005). However, it is important to ensure that outside directors have enough time to devote to a particular firm, as large additional directorships may limit the directors governing effectiveness as they are not able to understand each business well enough in performing their monitoring role (Bathala and Rao, 2005; Bedard *et al.*, 2004). Due to competitive disadvantage, potential conflicts of interests and less commitment, it is possible to predict a negative impact of directorship interlocks on firm performance.

Consistent with this notion, Devos *et al.* (2009) document that the presence of interlocked directors is associated with lower industry-adjusted firm performance, lower than optimal pay-performance sensitivity of CEO incentive compensation and reduced sensitivity of CEO turnover to firm performance. Collectively, their results suggest that the presence of interlocked directors is indicative of poorly governed firms. Haniffa and Hudaib (2006) report a negative significant relationship between multiple directorships and market performance and suggest that the market perceives multiple directorships as unhealthy and that they do not add value to corporate performance in Malaysia.

3. Sample description and variable measurement

3.1 Sample selection

The sample that we examine in this study consists of those firms listed on Bursa Malaysia's Main board for the period 1998 to 2005. We studied Malaysian firms because the incidence of board interlocks is high relative to the qualified independent directors[2]. There are strict data requirements for the accrual quality estimation that requires at least five year's residual value (Dechow and Dichev, 2002). For a sample of two years period (2003 and 2004), eight years complete accounting data, t = 1998-2005 for current assets, current liabilities, cash, change in debt in current liabilities, cash flow from operations, revenues and property, plant and equipment is required to estimate accrual quality. At the end of 2003, there were 598 financial and non-financial companies listed on Bursa Malaysia's Main Board. After eliminating all finance related firms (Davidson *et al.*, 2005; Peasnell *et al.*, 2005), industries with less than eight firms (Davidson *et al.*, 2005; Hashim and Devi, 2008) and complete corporate governance data, the final sample consist of 277 non-financial companies listed on Bursa Malaysia's Main Board from 2003 to 2004. This gives a total of 554 firm-years observations with complete data for dependent and independent variable.

3.2 Regression model

We use a linear multiple regression analysis to test the association between the dependent variable of earnings quality and the independent variable of the presence of interlocked directors on board. The following multiple regression model was utilised to determine the extent of the influence of each of the variables in the study on the earnings quality:

$$EQ = \beta_0 + \beta_1\, INTERLOCK + \beta_2\, BIND + \beta_3\, BSIZE + \beta_4\, BOWNS + \beta_5\, LNSALES + \beta_6\, LEV + \beta_7\, ROA + \varepsilon \quad (1)$$

Where;

EQ	=	Standard deviation of accrual quality residuals
INTERLOCK	=	The proportion of directors on the board with directorships in other companies to the total number of directors on the board of the company
BIND	=	The proportion of independent non-executive directors to the total number of directors on the board of the company
BSIZE	=	Total number of directors on the board of the company
BOWNS	=	The percentage of shares held by outside directors to total number of shares issued
LNSALES	=	Natural log of total sales
LEV	=	The ratio of total liabilities to total assets
ROA	=	The ratio of net income to total assets
ε	=	Error term

The dependent variable is earnings quality *(EQ)* measured by standard deviation of accrual quality residuals. The independent variable consists of directorship interlocks *(INTERLOCK)*. Consistent with prior studies (Ferris *et al.*, 2003; Devos *et al.*, 2009), we include board independence (*BIND)*, board size *(BSIZE)*, outside directors' ownership *(BOWNS)*, firm size *(LNSALES)*, leverage *(LEV)* and return on assets *(ROA)* as control variables in the regression model. Earnings quality accounting data was extracted from financial databases such as the DataStream and the OSIRIS. Any missing financial data from the databases was obtained manually from the respective annual reports. Information pertaining to independent and controlled variables was manually-collected by examining the disclosures made in annual reports available on the Bursa Malaysia website (www.bursamalaysia.com).

3.3 Dependent variable

[2] Study by Norman *et al.* (2005) report an average of 57 percent of the board members in Malaysia have multiple directorships as measured by ratio of members on the board with multiple directorships to total members.

We adopt Dechow and Dichev (2002) accrual quality model to measure earnings quality. In the Dechow and Dichev (2002) study, the estimated residuals from firm specific regressions of working capital accruals, on past, present, and future cash flow from operation, captures the total accruals estimation error by management and are viewed as an inverse measure of earnings quality. The Dechow and Dichev (2002) model is measured by estimating the following regression (all variables are scaled by average assets):

$$\Delta TCA_{j,t} = \varphi_{0,j} + \varphi_{1,j}\, CFO_{j,t-1} + \varphi_{2,j}\, CFO_{j,t} + \varphi_{3,j}\, CFO_{j,t+1} + \nu_{j,t} \quad \text{..............(2)}$$

Where, $\Delta TCA_{j,t}$ is the firm *j*'s total current accruals in year *t*, = ($\Delta CA_{j,t}$ - $\Delta CL_{j,t}$ - $\Delta Cash_{j,t}$ + $\Delta STDEBT_{j,t}$); $\Delta CA_{j,t}$ the firm *j*'s change in current assets between year *t-1* and year *t*; $\Delta CL_{j,t}$ the firm *j*'s change in current liabilities between year *t-1* and year *t*; $\Delta Cash_{j,t}$ the firm *j*'s change in cash between year *t-1* and year *t*; $\Delta STDEBT_{j,t}$ the firm *j*'s change in debt in current liabilities between year *t-1* and year *t*; $Assets_{j,t}$ the firm *j*'s average total assets in year *t* and *t-1*; and $CFO_{j,t}$ the firm *j*'s net cash flow from operation in year *t*. For each firm-year, equation 2 is estimated cross-sectionally for all firms (minimum of eight firms within each industry group). These estimations yield five firm- and year-specific residuals, $\nu_{j,t}$, $t = t\text{-}4, \ldots t$, which form the basis for the accrual metric. Accrual Quality $_{j,t}$ = $\sigma(\nu_{j,t})$, is equal to the standard deviation of the firm *j*'s estimated residuals. (Note: the standard deviation score is multiplied by -1 so that a higher score indicates higher earnings quality)

4. Results and discussions

4.1 Descriptive statistics

Table 1: Descriptive Statistics for Dependent and Independent Variables

	Mean	Median	Standard Deviation	Minimum	Maximum
Continuous Variables					
EQ	-0.76	-0.56	0.70	-5.28	-0.05
INTERLOCK	0.54	0.56	0.28	0.00	1.00
BIND	0.41	0.38	0.11	0.17	0.86
BSIZE	7.91	8.00	1.99	3.00	16.00
BOWNS	0.29	0.00	0.93	0.00	9.90
LNSALES	19.45	19.43	1.45	15.16	23.42
LEV	0.49	0.45	0.49	0.02	7.10
ROA	0.03	0.04	0.14	-1.60	2.01

Table 1 presents the descriptive statistics of the continuous and dichotomous variables used in this study. The mean and median values of earnings quality variable are -0.76 and -0.56, respectively. The maximum value and the standard deviations of residuals for the earnings quality variable are -0.05 and -0.70, respectively. In terms of directors' interlocks, more than half the board members (54 percent) hold additional directorships in other firms. Almost 30 percent of the sample firms are having 75 percent or more directors on the board with directorships in other companies. For board independence, the average, 41 percent, indicates the domination of insiders in the board composition of companies in Malaysia. With regards to outside ownership (independent non executive directors' interest), the percentage ranges from zero to 9.9 percent with an average value of 29 percent. The mean firm size, as represented by total sales of the firm, is RM 826,060,000. The averages for firm leverage and return on assets is 49 percent and 3 percent, respectively.

4.2 Correlation analysis

Table 2: Pearson Product Moment Correlation Coefficient *(N=554)*

	EQ	***INTERLOCK***	***BIND***	***BSIZE***	***BOWNS***	***LNSALES***	***LEV***	***ROA***
EQ	1							
INTERLOCK	.179**	1						
BIND	-.049	.132**	1					
BSIZE	.023	.101*	-.222**	1				
BOWNS	.089*	.065	.029	.168**	1			
LNSALES	.152**	.324**	-.021	.288**	-.023	1		
LEV	-.056	.040	-.064	.021	-.017	.151**	1	
ROA	.001	.017	.055	.106*	.043	.179**	-.042	1

** Correlation is significant at the 0.01 level (2-tailed).
* Correlation is significant at the 0.05 level (2-tailed).

With respect to correlation among variables, the correlation matrix tested in the study confirms that no multicollinearity exists between the variable since none of the variables correlates above 0.40.

4.3 Multivariate analysis

Table 3: Regression Results

Variable	*Model 1*	*Model 2*	*Model 3*
C	-1.816*** **(-4.263)**	-1.837*** **(-3.854)**	-1.971*** **(-4.590)**
INTERLOCK	0.368*** **(3.357)**		1.297*** **(3.142)**
INTERLOCK_DUM		0.570*** **(3.533)**	
INTERLOCK^2			-0.859** **(-2.334)**
BIND	-0.554** **(-2.013)**	-0.579** **(-2.071)**	-0.559** **(-2.039)**
BSIZE	-.022 (-1.405)	-0.022 (-1.317)	-0.027* **(-1.675)**
BOWNS	0.071** **(2.238)**	0.072** **(2.252)**	0.067** **(2.129)**
BMEET			
LNSALES	0.067*** **(2.979)**	0.048* **(1.943)**	0.068*** **(3.016)**
LEV	-0.123** **(-2.070)**	-0.095 (-1.599)	-0.122** **(-2.058)**
ROA	-0.112 (-0.538)	-0.036 (-0.176)	-0.136 (-0.657)
Adjusted R^2	0.052	0.034	0.060
F-statistic	5.339	3.745	5.391
Prob(*F*-statistic)	0.000	0.001	0.000

Notes: N = 554, *t*-statistics in parentheses.
***Significant at 0.01 level; **Significant at 0.05 level; *Significant at 0.1 level.

From the analysis conducted in *Model 1*, it is found that the presence of interlocked directors on board (*INTERLOCK*) proxy by proportion of directors on the board with directorships in other companies is highly significant at the 1 percent level. The result shows positive and significant result between the presence of interlocked directors on board and earnings quality. The greater the number of the board's committee holding additional directorships in other firms (i.e. interlocking directorates) enhances the quality of financial reporting of the firm as they gain governance expertise through knowledge they acquire in other firms (Bedard *et al.*, 2004). The result of this study is consistent with the prior study by Norman *et al.* (2005) that reported a positive contribution from directors with multiple directorships in mitigating earnings management in Malaysia. They suggest that the experience of directors with multiple directorships is important as a monitoring mechanism in mitigating earnings management activity. Furthermore, Harris and Shimizu (2004, p.793) claim that '*busy directors are busy for good reason – they are good contributors*'. The accumulated knowledge represented by the interlocking directorates enhanced board effectiveness that offsets the accompanying negative aspect of directors' busyness (Harris and Shimizu, 2004).

4.4 Additional analysis

To ascertain the credibility of initial analysis, two additional tests were carried out; (1) using a different proxy to measure directors' interlocks; and (2) allowing for a possible non-linear relationship between directors' interlocks and earnings quality.

4.4.1 Alternative measurement for directors' interlocks – dichotomous variable

As reported in *Model 2*, the overall results as well as the individual results do not change significantly from the basic model (*Model 1*).

As for the results regarding the directors' interlocks, treating the board interlocks variable as a dummy variable do influence earnings quality significantly. Specifically, the results show highly significant coefficient with regards to the association between directors' interlocks and earnings quality for pooled data.

4.4.2 Alternative measurement for directors' interlocks – square of directors' interlocks

Thus far, the variable *INTERLOCK* is treated as a linear variable. It is possible that the relationship between the presences of interlocked directors on board is non-linear. Study by Jiraporn *et al.* (2009b) suggests that the relation between the number of outside directorships and the number of internal board committee on which the director serves is non-linear, U-shaped and in support for both the busyness and the reputation hypotheses.

For example, Jiraporn *et al.* (2009b) suggest that at lower level of multiple board seats, directors holding more board seats tend to serve on fewer board committees which supported the busyness hypothesis. The cost of busyness seems to outweigh the benefits of reputation. On the other hand, at higher level of board seats, the benefits of reputation outweigh the cost of being busy, leading busy directors to serve on higher number of committees which supported the reputation hypothesis.

To further investigate this issue, the study adds a squared term for directors' interlocks ($INTERLOCK^2$) to the basic model to test whether the relation between the presence of interlocked directors on board and earnings quality is non-linear. Results reported in *Model 3* indicate that both the estimated coefficient of directors' interlocks (*INTERLOCK*) and the square directors' interlocks ($INTERLOCK^2$) are statistically significant at the 1 percent level and 5 percent level, respectively. Other individual results are not significantly different from the earlier model except board size variable become significant in *Model 3* at 10 percent level.

Given the estimated values for the *INTERLOCK* and $INTERLOCK^2$ coefficients, the turning point of the relation between the presence of interlocked directors on board and earnings quality is:

Maximisation point = $-b_2/2b_3 = -1.297/ (2*-.859) = 75.49\% \approx 75\%$

The results suggest that as the presence of interlocked directors on board increases, the sample firms report higher earnings quality, consistent with the agency theory prediction. However, when the proportion of directors on the board with directorships in other companies to the total number of directors reaches beyond 75 percent, a negative association between the presence of interlocked directors on board and earnings quality emerges. In other words, the results suggest that firms with the presence of interlocked directors on board greater than 75 percent will begin to report lower earnings quality. The finding of this additional analysis may supports the busyness hypothesis that suggests individuals holding too many outside board seats have less time to spend serving on board committees, thus reduce their monitoring effectiveness (Jiraporn *et al.*, 2009b).

4.5 Discussion on control variables

Out of six control variables included in the models, four were found to be significant. The coefficients on firm size (LNSIZE) and outside directors' ownership (BOWNS) are positive and significant at 1 percent level and 5 percent level, respectively. The coefficient for board independence (BIND) and leverage are negative and significant at 5 percent level, while the coefficient for board size (BSIZE) is negative and significant at 10 percent level. The results may imply that firms with greater inside board members, higher outside ownership, smaller board, large firms and lower debts are associated with higher earnings quality.

5 Conclusions

Our study seeks to understand the phenomenon of interlocking directorates and their relationship to financial reporting quality. We document that an increase in the presence of interlocked directors on a board has a positive role in determining the quality of earnings in Malaysia. It appears that the presence of interlocked directors on a board provides an incentive for diligent monitoring as they have the knowledge, expertise, skill and stronger incentive to actively monitor the actions of management and improve the quality of financial reporting upon their experiences from other board. These findings are consistent with Ferris *et al.* (2003), Harris and Shimizu (2004) and Stuart and Yim (2010) findings on the importance of experience and expert advisory by reputed directors on board. Nevertheless, too many members in a firm with interlocking directorates appear to deteriorate the quality of earnings. Thus, limiting the number of directorships held by any one individual as suggested by corporate governance activists seems to be relevant for best corporate governance practices for Malaysian firms. This study has advanced our understanding on the effect of board interlocks on earnings quality in emerging economies, but it does have limitations.

One main limitation of this study is the measurement of directors' interlock. Even though Bursa Malaysia Listing Requirements limit the numbers of companies' director can serve in listed and unlisted companies, the detailed data is not available in the annual report. Perhaps, extensions of this investigation using individual interlocks will further enhance our understanding on the effect of overboarded directors on corporate reporting.

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