INDIAN INSTITUTE OF MANAGEMENT
AHMEDABAD • INDIA

Research and Publications

Impact of Independent Directors' Resignations on Firm's Governance

Preet Deep Singh
Chitra Singla

W.P. No. 2016-03-36
March 2016

INDIAN INSTITUTE OF MANAGEMENT
AHMEDABAD-380 015
INDIA

Impact of Independent Directors' Resignations on Firm's Governance

Preet Deep Singh
Doctoral Student, Indian Institute of Management, Ahmedabad
e-mail: preetds@iimahd.ernet.in

Chitra Singla
Indian Institute of Management, Ahmedabad
e-mail: chitras@iima.ac.in

Abstract

Directors are liable for any act of omission or commission. They have a reputation to protect. While Independent directors might engage in passive monitoring; when apprised of a decision where the probability of detection of negligence is higher, they might prefer to abandon ship rather than suffer consequences. Under such circumstances, directors' resignations could lead to some consequences on firm's governance. We test this using a sample of more than 2300 resignations during 2006-2014 from firms listed on National Stock Exchange, India. We specifically identify clustered resignations, i.e., when 2 or more people leave the board within the same year for company-specific reasons and see its association with earnings management in the following year.

Impact of Independent Directors' Resignations on Firm's Governance

INTRODUCTION

Role of a board of a firm is to represent shareholders' interests to the management and therefore, board members have a fiduciary responsibility towards the shareholders of the firm. Board members oversee management and its actions and work towards longevity of the firm. In addition to this monitoring role, board members play role of advisors, strategists, conflict resolver, and reviewer of board's performance. Current corporate governance norms worldwide have extended the responsibility of the board from shareholders to stakeholders. Given the responsible role that board members play, media, public, and investors watch board's actions and decisions closely to get some idea about firm's performance and governance. In fact, literature suggests that investment decisions of many investors especially the foreign institutional investors are dependent upon board's composition and leadership. In terms of board composition, investors prefer more number of outside directors and preferably independent directors on board of the firm. In terms of leadership, CEO duality (CEO and Chairperson if the board are same individual) is not a preferred choice of investors. On the basis of this fact, we argue that resignation of independent board members could impact performance and governance of the firms. We speculate the relationship between board members' resignation and firm's management (measured as earning management) on the basis of some examples we recently saw in the Corporate World.

To list a few, five of Kingfisher Airline Limited's directors resigned around adverse media publicity and other problems. Recently two directors of OnMobile Global Limited resigned months before KPMG showered criticism on the management in a forensic report[1]. Outside directors, and more specifically independent directors usually draw attention of public and media post a corporate failure. Mostly, media coverages consist of news related to directors'

[1] http://www.livemint.com/Companies/1fZ5yrYIGe0dFdeeb7Q2QL/Are-longserving-independent-directors-truly-independent.html, accessed on Mar 28, 2016.

resignations and their (in)active roles as board members. We build on this line of thought and make an attempt to examine if director resignation in clusters, where two or more directors of a firm resign in the same year, has some predictive ability about the management of the firm. We proxy for 'management of the firm' in terms of earnings management. Using a dataset on Indian firms from a period of 2006-2015, we show that there is a negative relation between clustered resignation and earnings management in the following year indicating that the firm's tendency to manipulate earnings decreases after directors resign from the board.

Literature Review and Hypothesis

Reasons for the resignations of directors are shrouded in mystery for outsiders. It could be the result of a tiff, an ego clash, busyness, or in order to distance oneself from possible repercussions of an action. Directors' resignations can signal governance failure in a firm. There are two main reasons, that are cited in the extant literature, for directors' resignations: Jumping ship (Semadeni et al., 2008) and Cleaning house (Arthaud-Day et al., 2006; Cowen and Marcel, 2011; Karpoff and Lott, 1993).

'Jumping ship' is related to director's reputation where directors resign from the firm when some kind of wrong doings/fraud is being carried out inside the firm. Directors are worried about their reputation in the corporate world and therefore they quit the troubled firm to avoid any false blaming (Bolvie, Graffin, and Pollock, 2012; Semadeni et al., 2008).

'Cleaning house' is related to threat to organization legitimacy due to governance failures; this means that organization is subjected to scrutiny by external bodies that could cut off resource supply to firms. Board can ask directors to resign for their inactive role and/or wrong decisions before the firm actually goes bankrupt so that their bad image would not act as a hindrance for resource acquisition by the firm from external environment.

To summarize, jumping ship is a director's initiative while cleaning house is a board's initiative to get rid of not-so-good directors. In either case, directors' resignation signal potential governance failure in the firm.

In case it is something specific to an individual, there should only be one resignation. However, if it is to distance oneself from the outcome of a wrong decision, it is likely that more than one director would resign as the negatives would be applicable to all of them to some extent. Therefore, literature has looked at clustered resignations of outside and/or independent directors where more than one outside director has resigned in a year

On the basis of above two concepts, researchers have done some empirical work to look at both antecedents as well as consequences of directors' resignation in a firm.

Antecedents to Director Resignations

Researchers have looked at various causes for directors' resignations; many of them are related to poor performance in the past, impending bankruptcy, and private restructuring of debt. Brown & Maloney (1999), using a sample of acquisition-attempt companies from 1980s, find that poor performance follows higher outside director turnover and lower inside director turnover. They attribute outside director turnover to their preference to leave the board rather than act to tackle the problem. Gilson (1990) looks at 111 publicly traded firms that have major changes on their board following a bankruptcy or a private restructuring of their debt. They find that more than 50% of the directors are shown the door. Those that are relieved hold fewer seats on other boards following their exit. Thus, even in companies undergoing financial distress, it is not beneficial for directors to resign.

However, there is ambiguity in literature on this finding. Hermalin & Weisbach (1988) find an increase in outside directors following a phase of bad performance, which could be driven by a demand for strategic inputs. Results from Brickley, Coles, & Terry (1994) suggest that evaluation of strategic decisions is within the ambit of responsibilities of outside directors.

Regulators have made the folly of looking at only the number but not the power and impact of independent directors. Research has shown that outside directors are not as effective as regulators might feel (Mace 1971). In fact using survey data Mace (1971) shows that outside directors would rather resign than raise their voice. Those who do raise their voice, are forced to resign. Some researchers have cited appointment of new CEO, forced CEO succession, and failure to monitor the management as reasons for directors exit from the firm. Some of these reasons explain director's decision to resign and others explain board's decision to ask the director to leave.

Hermalin & Weisbach (1988) argue that in case new inside directors are added to the Board as prospective candidates to be the next CEO, once a new CEO is selected, the unsuccessful candidates would resign. Resignation of these directors should not signal wrong doing in the company. According to observable characteristics, these new directors would resign within two years of their appointment, and would surround the exit of the previous CEO and the appointment of another inside director as CEO.

Further, Farrell & Whidbee (2000) identify the type of outside directors who resign after a forced CEO succession. They are more likely to hold little equity, be aligned with the outgoing CEO and make poor replacement decisions. Again the signal from the resignation of these directors would not pertain to wrong doing within the firm. Also, the resignation of these directors would be clouded with effects of CEO succession.
In addition to this, Farrell & Whidbee (2000), in their study of forced CEO turnover, argue that in case the outside directors are not able to monitor effectively, they shall not be taken on more boards and their resignation from the current board is also more likely. They use a matched sample analysis to examine the likelihood of director turnover. Brown & Maloney (1999) argue

that the cost of resignation for directors is low and they do not want to be associated with poorly performing companies. Bar-Hava & Segal (2010) study the independent director resignations. Their results indicate that the likelihood of resignation increases with weak future performance. They examine the reasons provided by directors for resigning. When weak or ambiguous or unverifiable reasons are given, it is usually associated with recent, and future poor performance. Such resignations / reasons lead to a negative market reaction and downward forecast revisions.

Brown & Maloney (1999) present two sides of the argument when they say that either the director could choose to resign, avoid any repercussions and in the process might gain the reputation of a quitter. Alternatively, the director may choose to stand up against the CEO, be forced to resign and develop a reputation for ’rocking the boat’. Dewally & Peck 2010 examine motive and characteristics of directors who resign from boards of publicly listed companies. While retiring professional directors leave quietly, active professional directors retire with public notice. Many of the directors who leave the firm while criticizing it publically are finance professionals with committee memberships. The firms they resign from, have weak boards and financial performance.

On similar lines, Marcel & Cowen (2014) have empirically shown that directors with high social capital decide to resign from the board of the firm owing to poor performance of the firm; however, it is the board who asks directors with low social capital to leave the board when the firm is not performing well.

Using a theoretical lens of different identities, Withers, Corley, & Hillman (2012) examine the role and decision of directors to stay or leave, in times of crisis. They present arguments for staying with the company for tough times.

So far, we have looked at various antecedents of directors' resignations in the firm. There is also some work that looks at consequences of directors' resignations.

Consequences of directors' resignations

Gupta & Fields (2009) look at board member resignations and market reactions. Their study shows that the reaction is less negative when institutional ownership is high and when the board is more independent. This could be construed as the market treating this as a sign that there are backup governance mechanisms in place and if there were something seriously wrong, there would be activity on all these fronts. Similarly, the reaction is more negative for a higher level of an officer, and CEO performance based pay. A higher level officer foregoes more with resignation. Therefore, the benefit that he should derive has to be commensurate. In our story, the benefit is the reduction of liability arising out of possible misdoings. CEO performance based pay could proxy for his incentive to manage earnings.

Wu (2014) examines the timeliness of CEO resignations and its consequence in terms of market reaction. Market reaction is more negative, and people lose confidence in case of delayed resignations than if it is timely.

To summarize, most of the work in existing literature examines various causes for directors' resignation and there is limited work on consequences of directors' resignations. We build on this research gap by looking at impact of clustered resignations on firm's future earning management.

Hypotheses

Giving up directorships is like giving up a position of prestige; directors would be reluctant, or it could also indicate a loss of the reputation capital of the directors (Farrell & Whidbee 2000). Each director's benefit from resignation has to outweigh the cost of foregone future directorships. The benefits of resignation could be reputation, being distanced from a firm later identified for fraud, misreported earnings, lack of compliances, and imprudent business decisions. However, it is also possible that independent directors are leaving, not before but after the earnings management has occurred. Media reports also point to the fact that independent directors resign when certain issues are brought to light or are discussed internally. Therefore, it is possible that the exit of directors here might not be a sign of Independent directors' voting with their feet but of the directors deserting the company due to recently uncovered earnings management. It is possible that independent directors quit not in protest but fear. The difference between the two being that, they quit when they feel that the act of earnings management is surfacing and the possibility of detection of getting higher. This can be corroborated by the Kingfisher example, mentioned earlier. The directors did not quit when the company was making inappropriate decisions but when the heat from those decisions started to be felt. There could be a number of explanations for this. Independent directors might not be as diligent at the time of such decisions, and therefore they quit as soon as they get to know about it. Independent directors might approve of such decisions if it gives them the right to stay on the board, and when things go downhill they want to distance themselves from it.

Therefore, when independent directors resign from a firm's board, it sends strong signal to the market, especially the foreign investors. Consequently, the firm may start finding it difficult to procure resources from external environment and it could hamper firm's future performance. In addition to this, it would be difficult for the firm to get new independent directors on board to fill the seats vacated by earlier directors. Therefore, such a firm and its management and board are under tremendous pressure to follow good governance practices, rebuild the lost image and resend the right kind of signals to the market. Owing to this pressure, we expect management of this firm to have low earning management in the following year.

Therefore, we hypothesize that:

Hypothesis: Companies that see more than two or more independent directors resign in the same year will exhibit lower earnings management in the year following the resignation.

Data and Methodology

Design and Variables

We use Earning management as dependent variable in this study. Main independent variable is clustered resignations. We control for firm's size (measured as log of total assets), R&D expenses, and if securities are issued in that year or not in the regression.

As per Farrell & Whidbee (2000) a new CEO might want to reinstitute the board and work with a new team on the board. Therefore, we have to remove cases that were followed closely by a change in the CEO. Our sample restricts us to not look at a case like Microsoft where even after resigning from the post of CEO, the director remains on board. We can only look at cases where the CEO leaves the board. This is not much of a problem because in case the old CEO is still on the board, it means that he wields enough influence to ensure that other independent directors serve at his pleasure, and the new CEO might not want to appear too radical to make those changes.

We use the modified Jones (Dechow, Sloan, & Sweeney 1995) model to measure earnings management in these companies. Details on these variables can be found in Tables 1 and Table 2.

$$Y_{j,t} = \alpha(1/TA_{t-1}) + \beta_1(NiBeforePe_{t-1} - CFO_{t-1})/TA_{t-1} + \beta_2(\Delta Sales)/TA_{t-1} + \beta_3 PPE_{t-1}/TA_{t-1}$$

$$\epsilon_{j,t} = EarMan_t$$

$$\textit{Earning Management}_{t+1} = \gamma + \theta_1 \textit{Clustered Resignations}_t + \theta_2 \textit{Firm's size}_t + \theta_3 \textit{R\&D Expenses}_t + \theta_4 \textit{Securities issued}_t$$

Sample

We get data from Indian Boards Database from 2006 to 2014. We have 10742 resignations. We remove 168 as the date for those is not available. We then filter the data to include only Independent Directors. This leaves with 4989 observations. We remove cases with Nominee Directors and alternate directors. We remove cases where the reason for the resignation was not known. We further remove cases where the reason for resignation pertained to the expiry of the term, change in management, etc. We are left with 2375 resignations across the sample years. These are voluntary resignations of Independent Directors from companies with. From this sample, we remove 51 banks and 53 financial companies. This is because for these, accruals cannot be construed in the same way. We identify firms from where two or more independent directors have resigned in a given year. We get 323 firm observations and 275 unique firms across 2006-2014. We have to remove 9 cases for want of NIC code.

We then download data for all the companies available in Prowess (CMIE) database to calculate modified Jones discretionary accruals. We use all the companies available because the regression is run on groups based on Year and NIC Code. This is to control for any year effects and industry effect as some industries might have higher accruals by design. Once we get the residual values, we run a regression of the residuals on whether these companies had clustered resignations.

Results and Discussion

Table 3 shows the number of resignations per year. Table 4cshows the number of clustered resignations per year. While 67 independent directors resigned in 2007, there were only four companies from which multiple independent directors resigned. The usual trend is increasing over the years. The number of resignations increased from 88 in the year 2006, to 436 in 2014, and the number of clusters increased from 17 in 2006 to 87 in 2014. Table 5 shows descriptive statistics of variables.

Table 6 shows the results of a multivariate regression on Earnings Management in t+1 year. In the presence of other control variables, the magnitude of the coefficient of main independent variable (clustered resignations) is negative and significant at the 5% level. This means that even after controlling for other variables, the clustered exit of independent directors is associated with negative earnings management in the year following the resignations. This is as per our expectations and support our proposed hypothesis.

This indicates that firms want to control the damage done by directors resignations and therefore follow good governance by lowering earning management in the following year. This could mean that once these directors are replaced due to their resignation and company's efforts to bring in other directors; the new directors are more likely to rein in earnings management. Another explanation supporting this result could be that if directors are busy and they feel that they are not able to add enough value, they are likely to quit and those who feel they can add value would be more likely to join the board and that value is evident in the earnings management variable in the next year. This is also in line with with the findings of Withers et al. (2012) and Jiang et al. (n.d.).

Conclusion

Using a sample of more than 2300 resignations from the listed companies in the Indian context, we examine the impact of clustered resignations of independent directors on firm's earning management. Our results suggest that in the year following a clustered resignation, there is lower earnings management in such companies. We hypothesize that clustered resignations could signal poor governance to the external market about the focal firm. Therefore, it could potentially impact a firm's access to resources (like funds, human capital) in the external market and its market valuation. To control such damage, firms feel pressure to take measures that will reestablish firm's image in terms of governance. Companies are better off in terms of monitoring after these resignations. One far-fetched theory could be that these directors have resigned because they were fighting for lower manipulation and were successful to a certain extent. When the limit of their impact was reached, they quit. Their resignation could also have sent a signal to the auditors to be more careful because of which they would have not allowed for any flexibility in estimates. Also, resignations put the company in the media glare, and in order to make this time event-free, companies engage in conservative practices. The market would be able to understand that director resignations just before and around a media disclosure of bad news does not absolve them of their monitoring lapses. Therefore, where the literature argues that directors resign because there is poor governance in the firm, we are able to show that independent directors' resignation can also lead to positive changes in governance and less manipulation in earning management. Our work contributes to the existing literature in three ways: First, it is the first work of its kind from an emerging market that looks at consequence of directors' resignations. Our research is different from existing literature in four ways. Our data comprises Listed companies in India for the period 2006-2014. Considerable changes have come about during this period, such as the enactment of Sarbanes-Oxley Act (SOX), and scope and extent of director liability. This makes it interesting to test some of the existing theories on Indian context. We do not restrict our sample to companies that attempted acquisitions like some of the work done in the extant literature. Also, we do not look at firm performance but at discretionary accruals using Dechow et al. (1995). Finally, we use clustered resignations to justify the assumption that directors leave the firm owing to its poor performance or governance in the recent past. Third, ours is one of the preliminary study that looks at positive impact of directors resignations on firm's governance.

However, this work is not without limitations. One of the limitations of our research is that we proxy for managerial issues in terms of earnings management. Further, there could be an issue of reverse causality in our work; previous year's earning management could also impact clustered resignations and we need to control for this with better methodology.

Future research in this area can look at characteristics of the directors who resign; for example, resignation of a director with high social and reputational capital could have different consequences as compared to a director who is low on these parameters. Further, variables and their measures can be refined further.

References

Arthaud-Day M, Certo S, Dalton C, Dalton D. 2006. A changing of the guard: executive and director

turnover following corporate financial restatements. *Academy of Management Journal* **49**: 1119–1136.

Bar-Hava, K., & Segal, D. (2010). Do outside directors tell the truth, the whole truth, and nothing but the truth when they resign? *Available at SSRN 1547852*.

Brickley, J. A., Coles, J. L., & Terry, R. L. (1994). Outside directors and the adoption of poison pills. *Journal of Financial Economics*, *35*(3), 371–390.

Brown, W. O., & Maloney, M. T. (1999). Exit, voice, and the role of corporate directors: Evidence from acquisition performance. *Available at SSRN 160308*.

Cowen A, Marcel J. 2011. Damaged goods: board decisions to dismiss reputationally compromised directors.

Academy of Management Journal **54**: 509–527.

Dechow, P. M., Sloan, R. G., & Sweeney, A. P. (1995). Detecting earnings management. *Accounting review*, 193–225.

Dewally, M., & Peck, S. W. (2010). Upheaval in the boardroom: Outside director public resignations, motivations, and consequences. *Journal of Corporate Finance*, *16*(1), 38–52.

Fahlenbrach, R., Low, A., & Stulz, R. M. (2010). *The dark side of outside directors: Do they quit when they are most needed?* (Tech. Rep.). National Bureau of Economic Research.

Farrell, K. A., & Whidbee, D. A. (2000). The consequences of forced CEO succession for outside directors. *Journal of Business*, *73*(4), 597–627.

Gilson, S. C. (1990). Bankruptcy, boards, banks, and block holders: Evidence on changes in corporate ownership and control when firms default. *Journal of Financial Economics*, *27*(2), 355–387.

Gupta, M., & Fields, L. P. (2009). Board independence and corporate governance: Evidence from director resignations. *Journal of Business Finance & Accounting*, *36*(1-2), 161–184.

Hermalin, B. E., & Weisbach, M. S. (1988). The determinants of board composition. *Rand Journal of Economics*, *19*(4), 589–606.

Jiang, W., Wan, H., & Zhao, S. (n.d.). The two-sided career concerns of independent directors: Evidence from director voting.

Karpoff J, Lott J. 1993. The reputational penalty firms bear from committing criminal fraud. *Journal of Law*
and Economics **36**: 757–802.

Mace, M. L. (1971). Directors: Myth and reality.

Marcel, J. J., & Cowen, A.P. 2014. Cleaning house or jumping ship?
Understanding board upheaval following
Financial fraud. Strategic management journal, 35: 926-937.

Rosenstein, S., & Wyatt, J. G. (1990). Outside directors, board independence, and shareholder wealth. *Journal of financial Economics*, *26*(2), 175–191.

Semadeni M, Cannella A, Fraser D, Lee D. 2008. Fight or flight: managing stigma in executive careers. *Strategic*
Management Journal **29**: 557–567.

Withers, M. C., Corley, K. G., & Hillman, A. J. (2012). Stay or leave: Director identities and voluntary exit from the board during organizational crisis. *Organization Science*, *23*(3), 835– 850.

Wu, X. (2014). *Timely vs. delayed CEO resignation and company performance* (Unpublished doctoral dissertation). Concordia University.

Table 1: Explanation of variables in Equation

Name	**Variable**
Y	Total Accruals
j	firm
t	Year
NiBeforePe	Net income before Special Items
TA	Total assets
PPE	Property, plant and equipment
	Error Term

Table 2: Description of Variables

EM (Earning Management)= Jones_lhs	This is the amount of abnormal accruals calculated with the Jones(1991) model
Clustered Resignation	This is coded as 1 in case there is a clustered resignation in that year
Firm's size= Log of total assets	This is the log of total assets of the company
R&D Expenses	Total Expenditure incurred on Research and Development
SecIss= If issued securities in the period	This takes the value 1 in case the company has issued securities during the period else 0

Table 3: Number of Resignations per year

Year	Number of Resignations
2006	88
2007	67
2008	110
2009	315
2010	256
2011	310
2012	352
2013	441
2014	436
Grand Total	2375

Table 4: Number of Clustered Resignations per year

Year	Number of Clustered Resignations
2006	17
2007	4
2008	14
2009	50
2010	37
2011	53
2012	61
2013	82
2014	87

Table 5: Descriptive Stats

	Clustered Resignations	**E M_t**	**E M_t +1**	**E M_t +2**
Mean	0.40848	0.00850	-0.00939	0.0043332
Standard Error	0.010337	0.005307	0.016820	0.0049988
Standard Deviation	0.491662	0.23225	0.65341	0.225115
Sample Variance	0.241732	0.053942	0.42694	0.050677
Minimum	0	-2.58342	-16.46141	-2.74021
Maximum	1	5.670683	5.67068	2.6823
Count	2262	915	1509	2028

Table 6:: Multiple Regression Results

	Es **timate**	**St** **d Error**	**t** **value**	**P** **r(>|t|)**
Intercept	0.0 039008	0.1 649028	0 .024	0 .9811
Firm's size=Log of Total Assets	- 0.0009831	0.0 297605	- 0.033	0 .9737
Clustered Resignations	**- 0.2005026**	**0.0 962485**	**- 2.083**	**0 .0377***
Securities Issued	0.0 895869	0.7 280023	0 .123	0 .9021
R& D Expenses	0.0 001658	0.0 024394	0 .068	0 .9458