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THE EFFECT OF BOARD CLASSIFICATION IN THE RESTAURANT INDUSTRY

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ABSTRACT. Previous literature suggests that classified boards of directors could impact firm performance in the context of firm-specific characteristics. In continuation of this discussion, this study investigates the effect of classified boards on firm value in the restaurant industry. Even though classified boards can reduce firm value because of higher monitoring costs, existing literature argues that classified boards are devoted to protecting investors and shareholders against opportunistic bids, which in turn increases their debt financing capabilities. Data from U.S. restaurant firms was analyzed by Compustat and RiskMetrics from 2007–2011 to investigate whether classified boards impact firm value in the restaurant industry. Our results indicate that classified boards of directors lower the value destruction of restaurant firms in terms of cost of debt. That is, cost of debt is lower in classified board firms, thereby reducing their negative impact on firm value. The implications and limitation of this research are also discussed.

INTRODUCTION

In corporations, shareholders hire directors, and the directors hire managers (Chatfield & Dalbor, 2005; Core, Guay, & Rusticus, 2006). The purpose of the board of directors is to manage firms for the maximization of shareholders' wealth (Bates, Betcher, & Lemmon, 2008; La Porta, Lopez-de Silanes, Shleifer, & Vishny, 2002). Generally, the board of directors is elected annually; however, certain firms do not elect their board of directors on an annual basis (Gompers, Ishii, & Metrick, 2003; Harford, Li, & Zhao, 2008). Board classification refers to a continuing structure of direction for a certain portion of the directors by their unique classification (Falaye, 2007; Sundaramurthy, Mahoney, & Mahoney, 1997). Bebchuk, Cohen, and Farrell (2009) also noted that board classification is a staggered election structure of corporate governance, which could cause entrenchment.

A vast body of literature investigates the role of board classification in various contexts. For example, Chaganti, Mahajan, and Sharma (1985) examined the role of the board of

directors in the retailing industry context. Anderson and Fraser (2000) also investigated the role of the board of directors on decision-making in the banking industry. Moreover, Mayers, Shivdasani, and Smith (1997) identified the role of the board of directors for insurance firms. However, limited research has been undertaken in the hospitality industry context. Within the hospitality industry, the food service industry represents the largest scale of activity measured by sales. According to the Bureau of Economic Analysis (2010), the U.S. food service industry accounts for approximately \$800 billion of sales in 2009. In this large market, a number of restaurant firms are under competitive pressure, and firms are struggling to enhance their value. In this process, the role of the board of directors is critical, given that shareholders do not always see eye to eye with the management. Recently, shareholders in the McDonald's corporation claimed that declassification of the board would enhance the value of shares. However, the McDonald's corporation declined the request, emphasizing the importance of board

stability and continuity to ensure knowledge of McDonald's management system, which enables the firm to achieve ongoing success and create share value (McDonald's corporation, 2011).

Falaye (2007) verified that classified boards (also known as "staggered" boards) perform differently by types of firms, although it is value destroying in general. Obviously, restaurant firms have their own characteristics. For example, Guillet and Mattila (2010) note that restaurant firms are labor and capital intensive, have lower inventories compared to manufacturing firms, and have a high proportion of cost of goods. Furthermore, restaurant firms are represented by smaller firm size and higher profitability, compared with other hospitality industries (Inoue & Lee, 2011; Kang, Lee, & Huh, 2010). Given restaurant firms' unique financial characteristics, it would be reasonable to assume that a corporate board could have a different influence on a firm's value. However, limited studies have been conducted to test these effects of the board of directors in the restaurant context, to determine whether they impair the value of firms. Therefore, the purpose of this study is to fill this gap in governance literature of the restaurant industry. By examining the effect of the classified board of directors, this study contributes to further understanding of the impact of restaurant firms' financial characteristics.

LITERATURE REVIEW

Theoretical Foundation

Board classification is defined as a continuing structure of direction for a certain portion of the directors by their unique classification (Bebchuk et al., 2009; Falaye, 2007). Therefore, the board of directors is not annually elected under the classified board, even though the election of directors is a primary way for shareholders to take part in a corporate event (Bebchuk & Cohen, 2005; Chen, 2012). Agency theory is widely used to build the theoretical foundation of board classification. The theory focuses on the relationship between

shareholders and managers. Managers basically own superior information compared to shareholders in order to manage the overall business and to cope with uncertainties (Demsetz, 1983; Dewenter & Warther, 1998; Faleye, 2009). However, superior information allows managers the latitude to act for their own benefit instead of shareholders' wealth, which causes conflict with shareholders (Jensen, 1986; Stulz, 1990). Shareholders, thus, are required to monitor the manager, incurring costs for the sake of monitoring and preventing inappropriate actions by managers (Agrawal & Mandelker, 1990; Inderst & Ottaviani, 2009; Jensen & Meckling, 1976). Firms spend their resources for the purpose of monitoring, which consequently affects the value of the firm (Hermalin & Weisbach, 1998; Holmstrom, 1979; Sundaramurthy, Mahoney, & Mahoney, 1997).

Under board classification, the board of directors can allow shareholders limited access to information (Bates et al., 2008; Chen, 2012; Harford, Mansi, & Maxwell, 2008). This limited access to information gives rise to increased uncertainty for shareholders and, therefore, perceived riskier conditions (Ertimur, Ferri, & Stubben, 2010; Huang, Lai, & Wen, 2008; Jensen, 1986; Kusnadi, 2011). Hence, shareholders spend more resources on monitoring, which diminishes the value of firms. Consequently, a classified board could hamper firm value enhancement as a result of increased monitoring costs.

Value Destruction Due to Classified Board

Previous studies found that a classified board is responsible for value destruction (Frakes, 2007; Harford, Li, et al., 2008). Scholars found that more difficulty in monitoring by the classified board accounts for destruction of a firm's value (John & Senbet, 1998; Chen, 2012). That is, a classified board is less likely to maximize shareholders' benefits. Hence, board classification causes managerial entrenchment, and the entrenched management could destroy firm value (Bates et al., 2008). A vast body of literature addresses the value-destroying feature of classified boards.

For example, Falaye (2007) verifies that a classified board is negatively related to a firm's value, measured by Tobin's Q. Bebchuk and Cohen (2005) and Brown and Caylor (2006) also tested the effect of board classification and they found that a classified board is value destroying by using examples of the publicly traded U.S. firms. Based on the prior empirical and theoretical evidence, this study assumes similar aspects of the classified board for restaurant firms. Therefore, this study proposes the following hypothesis:

H1: Classified boards lower the value of restaurant firms.

Classified Board and Cost of Capital

Board classification leads to stability and continuity of corporate governance because of its continuing structure (Harford, Li, et al., 2008). Stability enables classified boards to be prepared for all the potential bids in the event of a takeover (Ertugrul & Hedge, 2008). The upsurge of defending capabilities against takeover deter the opportunistic bids, which damages shareholders' wealth (Bates et al., 2008). Harford, Mansi, et al., (2008) also notes that a classified board enhances debt-financing capabilities because the board is more able to resist opportunistic takeover. Enhanced capacity of debt financing leads firms to protect shareholders. Chen (2012) also notes that shareholders are less concerned about hostile takeover under a classified board, and the reduced concern of shareholders facilitates more debt financing. A classified board could also reduce the cost of debt (Anderson, Mansi, & Reeb, 2004; Fischer, Gramlich, Miller, & White, 2009). Falaye (2007) also empirically demonstrates the defensive capabilities of a classified board against opportunistic bids, such as "blank check preferred" and "poison pill." Bebchuk, Coates, and Subramanian (2002) showed that classified-board-acquired firms could not obtain a high premium, despite successful bids. Hence, the enhanced capacity against an opportunistic bid serves to reduce financial risk and cost of debt (Bebchuk et al.,

2002; Ertugrul & Hedge, 2008; Jensen, 1986; Myer, 1977). Given the abundant empirical evidence, it is reasonably assumed that restaurant firms could gain from enhanced debt financing as a result of board classification. Therefore, current research suggests the following hypothesis:

H2: Classified board lowers the cost of debt.

METHODS

Data and Research Variables

The restaurant firms' financial data are derived from COMPUSTAT, using standard industry classification (SIC) code 5812. Risk-Metrics was employed to acquire information of classified boards. During the study period of 2007–2011, twenty-four restaurant firms were sampled. Cook's distance was applied using a threshold of 1 to detect outliers (Hair, Black, Babin, Anderson, & Tatham, 2010). Two outliers were eliminated from the sample based on the results of Cook's distance. The panel was formed as an unbalanced panel. The total number of observations was 118. Sampled firms are illustrated in Table 1.

The dependent variable of this study was Tobin's Q, which has been used as a representative measure of firm value in previous restaurant studies (Hsu & Jang, 2009; Koh, Lee, & Boo, 2009; Gompers et al., 2003;

TABLE 1. Sampled Restaurant Firms

Firm name (Ticker)	Firm name (Ticker)
Bob Evans Restaurant (BOBE)	McDonald's Corp (MCD)
Brinker International (EAT)	O'Charley's (CHUX)
BJ's Restaurants (BJRI)	Panera Bread (PNRA)
Burger King (BK-C)	PAPA John's International (PZZA)
Buffalo Wild Wings (BWLD)	P F Chang's China Bistro (PFCB)
CEC Entertainment (CEC)	Red Robin (RRGB)
Cheesecake Factory (CAKE)	Ruby Tuesday (RT)
CKE Restaurant (CKR)	Sonic Drive-in (SONC)
Chipotle Mexican Grill (CMG)	Starbucks (SBUX)
Cracker Barrel (CBRL)	Texas Roadhouse (TXRH)
Darden Restaurants (DRI)	Wendy's Co (WEN)
Jack In The Box (JACK)	YUM Brands (YUM)

Tobin, 1969). Moreover, Falaye (2007) and Bebcuk and Cohen (2005) also recommended Tobin's Q as an appropriate proxy of firm value in their classified board study. The main independent variables include return on assets (ROA), firm size measured by total assets (SIZE), financial leverage measured by debt ratio (DEBT), and classified board (CB) measured in binary format (1 = classified board; 0 = nonclassified board). Hsu and Jang (2009) and Koh et al., (2009) also employed the firm size, which is measured by total assets and financial leverage, to predict the firm's value in the restaurant context. Table 2 provides the variable definition and measurement.

Statistical Analysis

Natural log transformation was performed on SIZE, DEBT, and Q to obtain heteroskedasticity-corrected standard error and normality (Greene, 2006; Hair et al., 2009). Variation inflation factor (VIF) was used to test multicollinearity. According to Wooldridge (2009), the estimation was less likely to be impaired by the multicollinearity issue, if VIF is less than 10. Therefore, the estimation was not impaired by multicollinearity because overall VIF records less than five. Panel regression analysis was employed because the data are formed as panel data. This study performed the Breusch and Pagan Lagrangian multiplier test to identify the more appropriate model between the random effect model and pooled ordinary least squares (OLS) by comparing the

residual between the pooled model and the random effect model, which incorporated unobserved effects into the model for the purpose of minimizing the omitted variable bias (Gujarati & Porter, 2009; Greene, 2006). The test statistics of panel regression were not significant ($\chi^2 = 0.02$; $p = 0.92$). This indicates that the null hypothesis ($H_0: \sigma_\varepsilon = 0$) was not rejected. Therefore, pooled OLS regression was regarded as a more appropriate tool for the analysis. The classified board (CB) is used to test the first hypothesis, whereas the interaction between CB and $\ln$ (DEBT) is employed to test the second hypothesis. The following is the equation of the suggested regression analysis:

$$\begin{aligned} \ln Q = & \ln(\text{SIZE}) + \text{ROA} + \ln(\text{DEBT}) + \text{CB} \\ & + \text{CB} * \ln(\text{SIZE}) + \text{CB} * \text{ROA} \\ & + \text{CB} * \ln(\text{DEBT}) + \varepsilon \end{aligned}$$

*****Poor model: Tobin's Q will relate to ROA.

(Note: Classified board (CB): 1 = Classified board; 0 = Nonclassified board; Firm Size (SIZE): Total Assets; Return on Assets (ROA): Net Income/Total Assets; Leverage (DEBT): Total Debt/Total Assets; Q: Tobin's Q.)

RESULTS

Table 3 presents descriptive statistics of restaurant firms. The mean value of classified board (CB) is 0.5121. This indicates that 51.21% of the sample firms were managed by classified boards. The descriptive statistics also show the mean and standard deviation of SIZE (Mean = \$2,935 (in millions); Std. Dev. = \$6,052 (in millions)), ROA (Mean = 0.0633; Std. Dev. = 0.0602), DEBT (Mean = 0.5609; Std. Dev. = 0.2124), and Q (Mean = 1.4815; Std. Dev. = 1.1791). For the restaurant firms with board classification, the descriptive statistics record SIZE (Mean = \$3,139 (in millions); Std. Dev. = \$8,149 (in millions)), ROA (Mean = 0.0618; Std. Dev. = 0.0673), DEBT (Mean = 0.5239; Std. Dev. = 0.2283),

TABLE 2. Measurement of Variables

Variables	Description
Classified board (CB)	1 = Classified board; 0 = Nonclassified board
Firm Size (SIZE)	Total Assets
Return on Assets (ROA)	Net Income/Total Assets
Leverage (DEBT)	Total Debt/Total Assets
Tobin's Q (Q)	(MVE + PS + LIAB)/TA

Note: MVE = Market Value of Equity = Share Price * Number of Common Stock Outstanding; PS = Preferred Stock = Book value of the firm's preferred stock; LIAB = Book Value of Inventories + Book Value of Long-term Debt - Short-term Liability - Short-term Assets; and TA = Total Assets = Book Value of Total Assets.

TABLE 3. Descriptive Statistics

Variables	Mean	Std. Dev.	Minimum	Maximum
All (N = 118)				
CB	0.5121	0.5018	0	1
SIZE	2,935	6,052	194	32,989
ROA	0.0633	0.0602	-0.2547	0.1692
DEBT	0.5609	0.2124	0.1606	1.1358
Q	1.4815	1.1791	0.0818	7.4054
Classified board (N = 60)				
SIZE	3,139	8,149	194	32,989
ROA	0.0618	0.0673	-0.2546	0.1668
DEBT	0.5239	0.2283	0.1606	1.1358
Q	1.5696	1.4015	0.0818	7.4054
Nonclassified board (N = 58)				
SIZE	2,720	2,423	197	8,834
ROA	0.0649	0.0523	-0.1032	0.1692
DEBT	0.5997	0.1886	0.2270	1.0165
Q	1.3905	0.8968	0.1235	3.7733

Note: CB: 1 = Classified board; 0 = Nonclassified board; SIZE: Total Assets; ROA = Net Income/Total Assets; DEBT: Total Debt/Total Assets; Tobin's Q = (MVE + PS + LIAB)/TA. (Where, MVE = Market Value of Equity = Share Price * Number of Common Stock Outstanding; PS = Preferred Stock = Book value of the firm's preferred stock; LIAB = Book Value of Inventories + Book Value of Long-term Debt - Short-term Liability - Short-term Assets; and TA = Total Assets = Book Value of Total Assets)

and Q (Mean = 1.5696; Std. Dev. = 1.4015). In the case of restaurant firms with a nonclassified board, the descriptive statistics appear as SIZE (Mean = \$2,720 (in millions); Std. Dev. = \$2,423 (in millions)), ROA (Mean = 0.0649; Std. Dev. = 0.0523), DEBT (Mean = 0.5997; Std. Dev. = 0.1886), and Q (Mean = 1.3905; Std. Dev. = 0.8968).

Table 4 illustrates the results of the correlation matrix. Tobin's Q was significantly correlated to SIZE ($r = 0.2466$; $p < .01$), ROA ($r = 0.6299$; $p < .01$), and DEBT ($r = -0.3455$; $p < .01$). SIZE and ROA also

showed a significantly positive correlation ($r = 0.3318$; $p < .01$). DEBT and CB had a negative correlation ($r = -0.1791$; $p < .05$).

Table 5 presents the outcome of pooled OLS regression analysis. The significant attributes included SIZE ($\beta = 0.1573$; $p < .05$), ROA ($\beta = 10.6202$; $p < .01$), DEBT ($\beta = -3.3691$; $p < .01$), and CB*DEBT ($\beta = 1.6403$; $p < .05$). The F-statistics also confirmed the model significance ($p < .01$). The R-squared value suggests that the model accounted for approximately 77.44% of variability for the prediction of firm value. We found support only for the second hypothesis.

CONCLUSIONS, LIMITATIONS AND RECOMMENDATIONS

The purpose of this research was to investigate the effect of board classification on the value of restaurant firms. This study proposed two hypotheses:

H1: Classified boards will reduce value

H2: Classified boards will reduce cost of debt of restaurant firms.

The variable of classified board (CB) did not report significant results for the first hypothesized models. This indicates that the first hypothesis was not supported for our sample. However, the regression output does show that the statistical significance for the interaction variable between CB and debt ratio (DEBT). The coefficient had a positive coefficient; however, the magnitude of interaction ($\beta = 1.6403$) was smaller than the raw variable of DEBT

TABLE 4. Summary of Correlation Matrix (N = 118)

	Q	SIZE	ROA	DEBT	CB
Q	1				
SIZE	0.2466**	1			
ROA	0.6299**	0.3318**	1		
DEBT	-0.3455**	0.0664	-0.0015	1	
CB	0.0763	0.0347	-0.0255	-0.1791*	1

Note: CB: 1 = Classified board; 0 = Nonclassified board; SIZE: Total Assets; ROA = Net Income/Total Assets; DEBT: Total Debt/Total Assets; Tobin's Q = (MVE + PS + LIAB)/TA (Where, MVE = Market Value of Equity = Share Price * Number of Common Stock Outstanding; PS = Preferred Stock = Book value of the firm's preferred stock; LIAB = Book Value of Inventories + Book Value of Long-term Debt - Short-term Liability - Short-term Assets; and TA = Total Assets = Book Value of Total Assets), * $p < .05$, ** $p < .01$.

TABLE 5. Regression Analysis With Pooled OLS (N = 118)

Study Variables	Coefficient (t-stat)	VIF
Intercept	-0.2162 (-0.74)	
SIZE	0.1573 (2.44)*	4.23
ROA	10.6202 (7.71)**	4.14
DEBT	-3.3691 (-5.92)**	3.02
CB	0.1937(0.50)	1.25
CB*SIZE	-0.1146(-1.56)	3.67
CB*ROA	-1.4924 (0.87)	3.55
CB*DEBT	1.6403 (2.31)*	2.49

F-statistics = 34.93**, Adjusted R² = 0.7744.

Note: CB: 1 = Classified board; 0 = Nonclassified board; SIZE: Total Assets; ROA = Net Income/Total Assets; DEBT: Total Debt/Total Assets; Tobin's Q = (MVE + PS + LIAB)/TA (MVE = Market Value of Equity = Share Price * Number of Common Stock Outstanding; PS = Preferred Stock = Book value of the firm's preferred stock; LIAB = Book Value of Inventories + Book Value of Long-term Debt - Short-term Liability - Short-term Assets; and TA = Total Assets = Book Value of Total Assets), The dependent variable in this regression is Tobin's Q, * $p < .05$, ** $p < .01$.

($\beta = -3.3691$). However, the summation of effect magnitudes of DEBT on the firm value of restaurants was still negative ($\beta = -1.7288$). However, it is also important to note that this negative summation effect was lower for CB firms than for those that did not have CBs ($\beta = -3.3691$) ($\beta = -3.3691 + \text{interaction coefficient} \times 0$ for non-CB).

Falaye (2007) argues that a classified board performs differently in a certain type of firm; however, that study analyzed only the case of firms with large-firm size. Therefore, this research attempted to investigate the effect of a classified board on restaurant-firm value because restaurant firms exhibit relatively smaller firm size (Guillet & Mattila, 2010). In order to measure firm value, this study used Tobin's Q as the dependent variable. By examining the industry-oriented effect of board classification, this study presented a positively significant coefficient on the interaction between a classified board and financial leverage (DEBT). This indicates that board classification was not detrimental for restaurant firm value in this study sample. However, restaurant firms' value destruction is mitigated by lower cost of debt financing due to their board classification.

Moreover, this study used panel regression to analyze the data based on the results of Guillet and Mattila (2010). The Breusch and Pagan Lagrangian multiplier tests were used to select a robust model. This enabled us to choose between pooled OLS and random effect models, which incorporate unobserved effects to estimate robust coefficients (Wooldridge, 2009; Gujarati & Porter, 2009). Pooled OLS results did not show the statistical significance. It indicates that the value of restaurant firms was not predicted well by using only the CB itself. Moreover, this study found that SIZE and ROA enhanced a firm's value in the case of declassifying the board as well as the case of DEBT decreasing the restaurant firm's value, which is externally validated in previous studies (e.g., Hsu & Jang, 2009; Koh et al., 2009; Falaye, 2007; Bebchuk & Cohen, 2005). Financial leverage (DEBT) interacted with CB, and this also showed a positive coefficient, even though the magnitude was smaller than DEBT. Chen (2012) and Harford, Li, et al. (2008) verified that classified boards reduce the cost of debt by enhancing capabilities against opportunistic bids. Our study found this to be true also in the case of the restaurant industry. Hence, this research could contribute to hospitality literature by exploring the effect of board classification on restaurant industries' values.

The results of this study could provide an industry-oriented standard in terms of the effect of board classification on the value of restaurant firms. These findings could help alleviate the conflict between restaurant firms' shareholders. For instance, in the recent case of McDonald's corporation, this study would support the role of board classification in terms of lowering a corporation's debt financing. The results could help managers persuade shareholders to consider board classification because it could enable the management to expand its debt financing. Practitioners and executives in the restaurant firm can compare their circumstances and consider the option of establishing a classified board in the context of their debt financing needs. For instance, if a restaurant firm were either heavily dependent

on debt financing or vulnerable against opportunistic bids, the shareholders and board of directors could consider board classification in order to prevent losing their value by an opportunistic bid. Shareholders also could avoid the unnecessary monitoring of board classification if they were well informed about the effect of board classification on their firm's financial status. This enables restaurant firms to avoid resource depletion for unnecessary monitoring.

This study is not free of limitations. First, the sample size was not large because of the constrained data availability of classified boards in the restaurant industry from the RiskMetrics database. If a future study were performed with a larger sample size, the outcome would be more robust. Moreover, the sampled firms are mainly U.S. based. Therefore, the study results could be limited in terms of generalizability. Future studies would need to extend the scope to the international market such as the European or Asian market. Finally, future studies could extend such an analysis of classified boards for other hospitality industries, such as airline and lodging firms. The effect of a board of directors is more likely to appear different because each hospitality industry has unique financial characteristics.

AUTHOR NOTES

Joonho Moon is a Graduate Student and Amit Sharma is an Associate Professor, both in the School of Hospitality Management at The Pennsylvania State University in University Park, Pennsylvania.

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