

The role of board structure as an internal control mechanism in non-listed firms

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Abstract

In the context of ownership concentration, the aim of this study is to analyze the usefulness of the board of directors as an internal control mechanism and, in the case of family firms, also consider the generational effect. We examined the relation between firm performance and outside directors in SME non-listed family and non-family firms. Our findings show the existence of a negative impact of outside directors on firm performance in family firms, and the clear difference in behavior between family firms run by the first generation and those that are run by subsequent generations.

Key words: Outsider directors, generation, non-listed firms, family firms

1.- Introduction

Within the management research area, corporate governance is one of the topics receiving increased attention. Specifically, corporate board structure and its impact on firm behaviour is one of the most debated issues in literature today. There are many studies that analyse the board of directors from different perspectives. Some of them analyse the determinants of board composition (Fiegenger et al., 2000; Voordeckers et al., 2007; Jaskiewicz and Klein, 2007; Bammens et al., 2008). Minichilli et al. (2009) studied the antecedents of board tasks performance, developing and empirically testing a theoretical model on the impact of board characteristics on board task performance for a sample of 2000 largest Italian industrial companies. Other studies analyse the effect of board composition on firm performance but, in general, the empirical evidence is not conclusive. Some empirical findings regarding board composition towards performance finds that outside directors could improve board effectiveness and firm performance. For instance, Weisbach (1988), McKnight and Mira (2003) and Anderson and

Reeb (2004) find a positive and significant relationship between outsiders' proportion and firm value. However, others like Baysinger and Butler (1985), Hermalin and Weisbach (1991), and Agrawal and Knoeber (1996) find a negative relationship between the proportion of outside directors and firm performance. Dalton et al. (1998), De Andres et al. (2005) and Jackling and Johl (2009) find no relation between the two variables. Differences in findings have in part been attributable to the differences in the theoretical bases of investigation and different measure of firm performance (Jackling and Johl, 2009).

However there is little research on the effect of the role of outside directors on firm performance in family SMEs and those who do have often uncritically adapted concepts and theories developed for large corporations without adjusting the situation to differences in for example ownership involvement, and the general lack of internal resources that often characterize these ventures (Huse, 2000; Daily et al, 2002). There consequently seems to be deficiencies in our knowledge of the role and contribution of outside directors in SMEs (Gabrielson and Huse, 2005).

Boards of directors are a central institution in the internal governance of a company. In addition to strategic direction, they provide a key monitoring function in dealing with agency problems in the firm (Fama, 1980; Jensen, 1993). In a diffuse ownership context, the monitoring function must focus on reducing the agency problem between disperse shareholders and management (Hermalin and Weisbach, 2001). However, in the context of companies with high ownership concentration, the agency conflict in the firm is between controlling shareholders and minority shareholders (Lefort and Urzua, 2008). Like any other type of business organization, a family firm uses internal control mechanisms, such as a board of directors, to reduce the agency problem (Jensen and Meckling, 1976).

In the context of non-listed firms, studies specifically focused on the determinants of board of director composition in small and medium-sized firms are scarce. This is a surprising finding given the fact that the board in a private family and non-family firm context may fulfil several important roles with a likely positive influence on performance. Furthermore, the most of the evidence available at this moment come from an Anglo-Saxon environment (Voordeckers, Van Gils, Van den Heuvel, 2007). This paper specifically investigates aspects of family and non-family corporate governance linked to firm performance in European continental environment.

The aim of this study is to analyse the usefulness of the board of directors as an internal control mechanism and, in the case of family firms, also consider the generational effect. To test our hypothesis that outside directors moderate conflicts between opposing groups in the firm, we examined the relation between firm performance and board independence in family and non-family firms.

Our findings show the existence of a negative impact of outside directors on firm performance in family firms, and the clear difference in behaviour between family firms run by the first generation and those that are run by subsequent generations. In this case, the presence of outsiders on the board has a positive effect on performance when the firm is run by the first generation. When the firm is run by second and subsequent generations, the presence of outsiders has exactly the opposite effect on performance.

This study makes several important contributions to management research. Our findings provide a new perspective on the role that outsider directors play in corporate governance of family firms. Besides examining the board's role in controlling the manager shareholder agency problem, we also consider the role of the boards in mitigating moral hazard conflicts between shareholder groups with diverging interests in family firms. Previous studies focus on relatively large publicly-traded family firms, however we focus on SMEs non-listed firms because their findings may not extend to smaller firms.

In that context, the rest of the paper is organised as follows. Section 2 describes the theoretical basis and the hypotheses to examine. Section 3 sets out the data and procedures for analysis used in undertaking this empirical study. The main results of the investigation are presented in Sections 4. The next section presents and discusses the results. We conclude the paper in Section 6 with some conclusions and implications for management theory and practice, and indicate paths for further investigation. The paper ends with a list of bibliographical references.

2. Board composition and firm performance: Theoretical background and hypotheses

2.1. Literature review

Corporate board structure and its impact on firm behaviour is one of the most debated issues in literature today. In recent years, the debate has focused on the structure of the board of directors, the most outstanding governance mechanism of the internal control systems (Jensen, 1993). Scholars have suggested alternative explanations for the determinants of board structure. Board structure has relied heavily on agency theory concepts, focusing on the control function of the board. Agency theory treats the company as a nexus of contracts through which various participants transact with each other (Jensen and Meckling 1976). Since assets are the property of the shareholders, a principal-agent problem may arise because managers have to make decisions concerning the productive use of these assets. Installing a board of directors can be an effective instrument for monitoring top managers and coping with this problem and to reduce agency costs (Fama and Jensen 1983). Thus, agency theory is used to examine the role that the board of directors may play in contributing to the performance of the organizations they govern (Jackling and Johl, 2009). Moreover, this theory explains the relationship between the three parties involved in corporate governance: the owners, the board of directors and top managers. In a diffuse ownership context, the board of directors monitors the labour of management, becoming the first line of defence dispersed shareholders have against the actions of top managers (Hermalin and Weisbach, 2001)

The agency problem seems less important in the context of companies with high ownership concentration, given that the controlling shareholders have sufficient incentives, power and information to control top managers (Jensen and Meckling, 1976). This reduces monitoring costs and boosts profitability (Morck et al., 1988; Anderson and Reeb, 2003). Yet high ownership concentration can trigger other problems with corporate governance and other types of cost. If there are controlling shareholders, they are more likely to be able to use their power to undertake activities intended to obtain private profit to the detriment of minority shareholders' wealth (La Porta et al., 1999; Villalonga and Amit, 2006). Furthermore, this trend can be exacerbated in the case of family-controlled firms, where the agency costs may take the form of dividends and extraordinary remunerations or of the entrenchment of the family management team, showing certain expropriatory practices that ultimately reduce profitability (DeAngelo and De Angelo, 2000; Gómez-Mejía et al., 2001; Fan and Wong, 2002; Francis et al., 2005; Santana et al., 2007).

However, another group of authors believe that the distinctive features of family firms have a positive effect on their corporate behaviour. The family's interest in the long-term survival of the business and its concern to maintain the reputation of the firm and the family lead them to avoid acting opportunistically with the earnings obtained (Anderson and Reed, 2003; Wang, 2006). According to Schulze et al. (2001), while the main source of agency problems is the separation between ownership and monitoring, such problems do not exist in first-generation family firms, insofar as the same person is responsible for making management and supervision decisions. In these cases, the interests of principal and agent are aligned and there is an assurance that management will not expropriate the shareholders' wealth. As the family property is shared out amongst an increasingly large number of members of the family, conflicts may start to arise when the interests of the family members are not aligned and the agency relations between the various participants in the firm are conducted on the basis of economic and non-economic preferences (Chrisman et al, 2005; Sharma et al., 2007). If it is non-listed firm, the disciplinary pressure of external corporate governance mechanisms will be reduced, making it all the more necessary that the internal monitoring mechanisms help reduce or alleviate behaviour that could jeopardise business and family interests (Schulze et al., 2002; Van den Berghe and Carchon, 2003). Consequently, the fact that majority shareholders are family will influence the workings of the firm's internal corporate governance mechanisms. The board of directors of family firms is therefore a corporate governance element with different structure and characteristics to those of non-family firms.

Among the different dimensions of board of directors, board composition is one of the most important for the majority of research efforts on boards. Studies on board composition classify directors as either insiders (those who are directors and managers at the same time) or outsiders (non-manager directors),

since they can have quite different behaviour and incentives (de Andres et al., 2005). Most of the corporate governance codes developed at the country level and an international level (e.g., Sarbanes-Oxley Act in US, Combined Code in UK, Conthe Code in Spain, OECD Code) require boards of directors of firms to have a combination of inside and outside directors.

In the context of corporate governance, agency theory implies that adequate monitoring mechanisms need to be established to protect shareholders from management's self-interests and outside directors are supposed to be guardians of the shareholders' interests via monitoring. Therefore a high proportion of outside directors on the board could have a positive impact on performance by monitoring services (Fama and Jensen, 1983; Shleifer and Vishny, 1997). Support for the agency theory, scholars have suggested alternative explanations for the determinants of board composition. So, Hermalin and Weisbach (1998), Raheja (2005), Harris and Raviv (2006), and Adams and Ferreira (2007), model the theoretical determinants of board composition, specifically the roles of insiders and outsiders (Linck, Netter and Yang, 2008). For example, Raheja (2005) argues that insiders are an important source of firm-specific information for the board and their experience can improve firm performance, but they can have distorted objectives due to private benefits and lack of independence from the CEO. Compared to insiders, outsiders provide superior firm performance as a result of their more independent monitoring, but are less informed about the firm's constraints and opportunities. Hermalin and Weisbach (1991) support the argument that outside directors are more effective monitors and a critical disciplining device for managers but they posit no significant relationship between performance and outsiders' proportion on the board of directors.

In general, the empirical evidence is not conclusive, some empirical findings regarding board composition towards performance find that outside directors could improve board effectiveness and firm performance. For instance, Weisbach (1988) and McKnight and Mira (2003) find a positive and significant relationship between outsiders' proportion and firm value. However, others like Baysinger and Butler (1985), Hermalin and Weisbach (1991), and Agrawal and Kneiber (1996) find a negative relationship between the proportion of outside directors and firm performance. Differences in findings have in part been attributable to the differences in the theoretical bases of investigation and different measure of firm performance (Jackling and Johl, 2009).

2.2. Hypothesis development

The agency theory approach is adopted for the examination of board composition in this study. Fama and Jensen (1983) explain that board outsiders could strengthen the firm's value by lending experience and monitoring services. This paper focuses on a similar question, but within non-listed firms with high ownership concentration context.

In this context, the first hypothesis proposes that a higher proportion of outside directors on the board will monitor any management's self-interests, and therefore will be associated with a positive impact on performance (Jensen and Meckling, 1976; Fama and Jensen, 1983; Shleifer and Vishny, 1997). Accordingly the following hypothesis is presented:

H1: The proportion of board outsider directors of non-listed firms is positively associated with firm performance

This paper performs a regression analysis of firm value on a measure of the proportion of outsiders (the number of non-manager directors over the total number of directors) and a series of control variables. Firm value is proxied by the firm performance (ROA).

The empirical model is:

$$Y = \beta_0 + \beta_1 \text{OUTSIDERS} + \beta_2 \text{INSOWN} + \beta_3 \text{BOARDSIZE} + \beta_4 \text{GROWTHOP} + \beta_5 \text{LEV} + \beta_6 \text{SIZE} + \beta_7 \text{AGE} + \beta_8 \text{SECT} + \epsilon$$

Where Y is the firm performance and OUTSIDERS the Board of Director's composition, INSOWN represent insider ownership, BOARDSIZE the Board of Director's size, GROWTHOP the growth opportunity, LEV the leverage, SIZE the firm's size, AGE the firm's age and SECT the sector.

Gomez-Mejia et al. (2003) found that the market for corporate control is potentially less prevalent in family firms relative to non-family firms. Because the relative lack of some governance mechanisms in family firms, outside shareholders potentially rely on boards of directors to monitor and control family opportunism (Anderson and Reeb, 2004). In this case, boards of directors can have an especially important role in promoting firm performance when alternative governance mechanisms are weak (Westphal, 1999).

To enhance firm performance, board outsiders play an influential role in standing up to family opportunism and protecting the rights of all shareholders. Perhaps one of the largest impacts that outside directors make in protecting outside shareholders from self-dealing families, occurs when the board prevents an unqualified or incompetent family member from assuming the CEO post (Shleifer and Vishny, 1997). In the agency theoretic context, we anticipate fewer moral hazard conflicts between family shareholders and outside shareholders as the fraction of independent directors on the board increases. More specifically, if outside directors act to alleviate conflicts between family shareholders and minority shareholders, a positive relation between firm performance and outside directors in family firms is expected. As a result, the following hypothesis is presented:

H2: The proportion of board outside directors of non-listed family firms is positively associated with firm performance

The empirical model is:

$$Y = \beta_0 + (\beta_1 + \beta_2 FD) OUTSIDERS + \beta_3 INSOWN + \beta_4 BOARDSIZE + \beta_5 GROWTHOP + \beta_6 LEV + \beta_7 SIZE + \beta_8 AGE + \beta_9 SECT + \epsilon$$

OUTSIDERS is interacted with FD, a dummy variable that equal one when a company is a family firm and zero otherwise.

The generational phase of the family firm can be linked to the need for board control. In the agency theoretic context, in first generation family firms there is an alignment of interests between principal and agent, which ensures that management does not expropriate the wealth of shareholders. In subsequent generations, there is no necessarily a convergence of interests between different family branches, which leads to increased agency costs. In addition each family branch is likely to require the presence of a fully trusted relative on the board in order to represent branch's interests (Bammens et al., 2008). Excessive branch's family representation on the board relative to outside director presence increases the likelihood of family expropriation (Anderson and Reed, 2004). It is therefore expected a positive relation in first generation family firms between board composition and firm performance.

H3: The relationship between the proportion of board outside directors of non-listed family firms and firm performance is bigger in the first generation

$$Y = \beta_0 + (\beta_1 + \beta_2 GEN) OUTSIDERS + \beta_3 INSOWN + \beta_4 BOARDSIZE + \beta_5 GROWTHOP + \beta_6 LEV + \beta_7 SIZE + \beta_8 AGE + \beta_9 SECT + \epsilon$$

Where GEN is a dummy variable which represent the generation managing the firm that equal one when the family firm is managed by the first generation and zero otherwise.

3. - Empirical research: method, data and analysis

3.1. - Population and sample

We conducted this study on Spanish firms included in the SABI (Iberian Balance Sheet Analysis System) database for 2006. We imposed certain restrictions on this group of companies in order to reach a representative set of the population. First, we eliminated companies affected by special situations such as insolvency, winding-up, liquidation or zero activity. Second, restrictions concerning the legal form of companies were imposed: we focused on limited companies and private limited companies as they have a legal obligation to establish boards of directors. Third, we eliminated listed companies. Fourth, we studied only Spanish firms with more than 50 employees, i.e. companies large enough to ensure the existence of a suitable management team and a controlling board to monitor their performance. Finally, companies were required to have provided financial information in 2006. With this condition, the sample

under study comprised 3723 non-listed Spanish firms.

There is no official database of family firms, so there is no way of directly identifying family firms. Moreover, the lack of an agreed definition of family firm leads to the use of samples of convenience, or to firms being identified as family firms after the sample has been preselected (Daily and Dollinger, 1993; Schulze et al. 2001, 2003; Chua et al., 2003). Given these limitations, a detailed analysis of the information in databases and a survey are the only way of identifying family and non-family non-listed firms. This study has chosen a combination of these two methods of identification.

In this study, a family firm is taken to mean a firm that meets two conditions: a) a substantial common stock is held by the founder or family members, allowing them to exercise control over the firm, and also b) they participate actively in monitoring it. As per La Porta et al. (1999), we established 20% as the minimum percentage of a firm's equity considered as a controlling interest. To find compliance with these two conditions, we conducted an exhaustive review of shareholding structures (percentage of common stock) and composition (name and surnames (The Spanish surname system, whereby women never take their husband's surnames and children take both surnames (their father's and their mother's) makes second degree relationships (uncles, aunts, first cousins, etc.) easier to identify) of shareholders), and also examined the composition of the board of directors of each of the 3723 selected companies in the database.

We accordingly classify a firm as a family firm if the main shareholder is a person or a family with a minimum of 20% of firm equity and there are family relationships between this shareholder and directors, based on coincidence of surnames. The composition of the management was also reviewed in search of family relationships between shareholders and managers.

Of 3723 companies preselected, the original sample used in this study is a 2958 firm random sample. 586 firms responded to the questionnaire: 217 non-family firms (37%) and 369 family firms (63%) for which there were data on ownership structures, accounting variables and boards of directors.

3.2. – Data

Data were collected by means of telephone interviews, a method that ensures a high response rate, and financial reporting information was obtained from the SABI database. To guarantee the highest possible number of replies, managers were made aware of the study in advance by means of a letter indicating the purpose and importance of the research. In cases where they were reluctant to reply or made excuses, a date and time were arranged in advance for the telephone interview. The final response rate was approximately 19.81%, and the interviewees were persons responsible for management at the firms (financial managers in 56.48% of the cases, the CEO in 31.06%, the president in 1.54% of the cases, and others in 10.92%).

The questionnaire collects information on the variables required for the study that could not be obtained from the SABI database and which it was considered would be more reliably collected through a survey; in particular, information regarding the ownership structure and composition of the board and company management.

3.3. Definition of variables

Firm profitability: The firm's profitability, measured in terms of return on assets (ROA), was taken as a dependant variable. The ROA measures the capacity of a firm's assets to generate profits and it is considered to be a key factor in determining the firm's future investment (Masson, 2002). It is therefore used as an indicator of firm profitability.

The ROA has been defined as EBIT (earnings before interests and taxes) between total assets, not taking into account the firm's financial performance (Anderson and Reeb, 2003). EBIT is a traditional measurement which does not include capital costs, i.e. it only includes the operating margin and operating income.

Board composition: Theoretically, from an agency perspective, it is claimed that a greater proportion of outside directors on boards act to monitor independently in situations where a conflict of interest arises between the shareholders and managers. Agency theory is based on the premise that there is an inherent

conflict between the interests of a firm's owners and its management (Fama and Jensen, 1983).

A high proportion of outside directors on the board is therefore viewed as potentially having a positive impact on performance (Fama and Jensen, 1983; Jensen and Meckling, 1976; Shleifer and Vishny, 1997). A greater proportion of outside directors will monitor any self-interested actions by managers, and will therefore be associated with high corporate performance (Nicholson and Kiel, 2007).

This variable has been generated representing the composition of the board (OUTSIDERS), calculated as the percentage of external directors on the board (Anderson and Reeb, 2003; Barontini and Caprio, 2006). The function of this variable is to measure the board's monitoring capacity, in order to analyse its influence on the firm's profitability.

Family firm: One of the primary concerns in defining the independent variables has been to define the notion of the family firm. As mentioned with regard to selection of the sample, for the purposes of this research a family firm was considered to be one in which one or more families can be shown to have at least a 20% holding, allowing them to exercise control over the firm while at the same time they participate actively in management with family members on the board. The survey also shows the family's desire to remain in the business. Following Anderson and Reeb (2003) and Wang (2006), a dummy variable (FD) was created with a value of 1 when the firm meets the conditions necessary to be considered a family firm and 0 otherwise.

Generation managing the firm: Another dummy variable has been created for family firms to determine the generation heading the firm's management. Given the different characteristics displayed by family firms depending on the generation that manages them, it is necessary to make this distinction in order to obtain the conclusions in the most appropriate way, differentiating between the different possible types of family firm. We can thus determine whether the behaviour of family firms varies depending on the generation managing them. We therefore created the GEN variable, which takes value 1 if the firm is managed by the first generation and 0 otherwise.

Control variables: Following authors such as Anderson and Reeb (2003) and Villalonga and Amit (2006) we also created a variable to reflect **insider ownership** (INSOWN). This variable measures the percentage of ownership in the hands of inside directors and the CEO and was created to take into account the possible effects of incentives resulting from the proportion of ownership in the hands of insiders.

Board Size (BOARDSIZE) was measured using the natural logarithm of total number of members of the board of directors (Anderson and Reeb, 2003, De Andrés et al., 2005; Jackling and Johl, 2009).

Size of firm (SIZE) was measured using the natural logarithm of total assets (Anderson and Reeb, 2003; Carter et al., 2003; Barontini and Caprio, 2006; Wang, 2006; Santalo and Diestre, 2006).

The number of directors is a relevant feature that can have much to do with the board's monitoring and control activity. Whereas the ability of the board to monitor can increase as more directors are added, the benefits can be outweighed by the costs in terms of the poorer communication and decision-making associated with larger groups (Lipton and Lorsch, 1992; Jensen, 1993).

On the above basis and given the potential importance of board size, we also created a variable measured using the natural logarithm of the number of directors in the firms in the sample.

Growth opportunities (GROWTHOP), following Scherr and Hulburt (2001) were calculated as $\text{Sales}_0/\text{Sales}_{-1}$. In this case, firms that grew most in the past were considered to have most chance of growth in the future.

Borrowing level (LEV) was measured as the quotient between total debt and total assets, (Coles et al., 2005; Wang, 2006).

Firm age (AGE) was measured as the natural logarithm of the number of years since the firm was incorporated.

The sector (SECT) was measured by means of Dummy variables, using the standard industrial

classification (Clasificación Nacional de Actividades Económicas).

3.4. – Method

We apply a cross-sectional ordinary least-square (OLS) regression model to test the hypotheses presented in the preceding section. Drawing on previous research on corporate governance, we also include seven control variables to minimize specification bias in the hypothesis testing.

To analyse the different characteristics attributed to family firms depending on the generation managing the firm it is necessary to classify family firms according to the generation managing it. Consistent with Miller et al. (2007) we have generated three GEN variables. GEN1 takes value of 1 if the firm is managed by the first generation and 0 otherwise..

To test for multicollinearity, the VIF was calculated for each independent variable. Myers (1990) suggests that a VIF value of 10 and above is cause for concern. The results (not shown in this paper) indicate that all the independent variables had VIF values of less than 10.

4.- Results

Table 1 presents descriptive statistics for the variables in the analysis. We show mean values for family and nonfamily firms. Family firms in the sample show significantly more diversification, with nearly 64% reporting only one line of business, as compared to 88.46% of non-family ones. Insider ownership is higher in family firms mainly due to the CEO's percentage of ownership, which is, on average, 5% in nonfamily firms and 20% in family firms. There are not many differences in the proportion of outside directors in family firms than in non-family, and it is therefore necessary to determine the possible effect their presence might have on firm performance due to the greater monitoring capacity. From an agency perspective, it is claimed that a greater proportion of outside directors on boards act to monitor independently in situations where a conflict of interest arises between the shareholders and managers (Jackling and Johl, 2009). Return on assets, growth opportunities and leverage are not significantly different in family and nonfamily firms. Nonfamily firms are larger than family ones and family firms have an average age of 40 years, compared to 33 for nonfamily ones, suggesting that our firms are well established.

Table 3 sets out the results of our linear regression evaluating the influence of board composition on business performance for family and non-family firms.

In our first regression we examined the influence of outside directors on firm performance. As noted in Table 4 (column I), the overall model is significant (F statistic = 1.86; $p < 0.01$ and R^2 is 0.19). The results were not expected. Our results show a nonsignificant relationship ($\beta_1 = -0.0179$) between outsiders and firm performance. Thus, firm value seems to be insensitive to board composition. Hypothesis 1 was not supported. These results are consistent with some of the available empirical evidence (De Andres et al., 2005), showing that independent monitoring and control by outsiders does not necessarily imply efficiency improvements for the full sample. Instead, we divide the sample up into family firms and non-family ones and make two models.

To compare the effect of board structure on performance in family firms and non-family ones (column II, F statistic = 2.33; $p < 0.01$ and R^2 is 0.24), we introduce an interaction term between family firms and outsiders. The purpose of this interaction term is to capture the marginal influence of board independence in family firms relative to non-family ones. We can see that in the case of non-family firms, although the coefficient of the proportion of outsiders is positive ($\beta_1 = 0.0197$), it is not significant, and no relationship may therefore be concluded to exist between the two variables.

For family firms the results are surprising. The Hypothesis 2 predicted that the greater the fraction of outside directors in family firms, the better the performance of the firm. The coefficient β_2 is negative and significant, and the influence of outsiders in the board is therefore negative for firm performance. This relationship highlights the lower effectiveness of outside directors in terms of monitoring in these firms. The results (column III, F statistic = 2.21; $p < 0.01$ and R^2 is 0.21) are similar if we take only the family firms in the sample, a negative impact of outsiders on firm performance ($\beta_1 = -0.0471$).

Column IV (F statistic = 3.99; $p < 0.00$ and R^2 is 0.20) shows the effect of board composition in the family firms in the sample, but distinguishes between those run by the first generation and others.

When the family firm is run by subsequent generations to the first, the coefficient β_1 is negative (-0.0217) and significant, and the influence of outsiders on the board is therefore negative for performance. However, the coefficient for the interaction between the percentage of outsiders on the board and the dummy corresponding to the first generation (β_2) is positive (0.0647) and significant. We may therefore conclude that when the family firm is run by the first generation, the presence of outsiders on the board improves business performance ($\beta_1 + \beta_2 = 0.043$).

We may conclude from the results that Hypothesis 3 is accepted, and establish that a bigger relationship exists between board composition, measured as the percentage of outsiders on the board, and business performance in family firms run by the first generation.

The result shows a clear difference in behaviour between family firms run by the first generation and those that are run by subsequent generations. In this case, the presence of outsiders on the board has a positive effect on performance when the firm is run by the first generation.

5.- Discussion

The results were not expected. We do not find any robust relationship between outsiders and firm performance. Thus, Hypothesis 1 was not supported. These results are consistent with those obtained for other types of firms by authors such as Baysinger and Butler (1985), Hermalin and Weisbach (1991); Mehran (1995), Klein (1998), Baghat and Black (2000), De Andrés et al (2005) and Jackling and Johl (2009), who find no evidence relating the proportion of outsiders on the board and different measures of business performance or market value.

In the case of family firms, the negative relationship between the percentage of outsiders on the board and firm performance can again be seen; these results are consistent with studies indicating that firms with a majority of board outside directors have poorer performance (Yermack, 1996; Barnhart and Rosenstein, 1998; Agrawal and Knoeber, 1996).

These results appear to contradict the assumption that outside directors have an important monitoring function and in contrast justify the presence of insider directors in family firms in the sample.

The reasons put forward to explain the negative relationship between the presence of outside directors and performance vary. Hermalin and Weisbach (1991) suggest that both insider and outsider directors may fail to perform their job of representing shareholders' interests properly, i.e., it cannot be concluded that outsiders perform their activity better than insiders. Likewise, Mace (1986) and Vancil (1987) argue that inside directors facilitate the process of succession in the firm, offering advice and conveying knowledge to the CEO on the firm's day-to-day operations. The presence of insiders on the board makes it easier for the other directors to view them as potential top executives, since they can assess their skills more simply from seeing them act on the board itself (Bhagat and Black, 2000). Maug (1997) demonstrates that for firms with important information asymmetries –and this is the case of family firms– it is not optimal to increase monitoring through the incorporation of outsiders, since transferring specific knowledge about the firm to outsiders can prove costly. On the other hand, the CEO and management are characterised by their high level of commitment to the organisation and by sharing its values.

It also needs to be said that each type of director has a specific role on the board (Baysinger and Butler, 1985). Inside directors have a greater knowledge of the firm than outsiders (Raheja, 2005), who are often unfamiliar with the working of the firm. Outsiders' independence makes them quicker to react in a crisis situation, but they have a greater chance of making mistakes as a result of that lack of knowledge.

Despite the fact that measures for reforming business governance tend to support increased outsider representation on the board, in order to afford greater protection to shareholders' interests (Kesner et al., 1986; Rechner et al., 1993), the reality is that each firm has to decide the most suitable board make-up for its own characteristics.

The results show a clear difference in the behaviour of first-generation family firms and those run by

subsequent generations, when it comes to the effect of board composition on firm performance. When the family firm is run by the first generation, having outsiders on the board improves firm performance, implying that outside directors potentially play an influential role in moderating family power and alleviating conflicts amongst shareholder groups.

Taking into account the clearly differentiated behaviour of first-generation family firms and those run by subsequent generations, the reason may be that in the case of first generation firms, outsider directors really are more involved in their work on the board and perform their function effectively. First-generation family firms have a smaller proportion of outsider directors than family firms run by subsequent generations. Although they have a smaller presence, this may be the right composition for the first phase in the life of a family firm, when the insider directors' knowledge of the firm's strategic planning is needed; given the long-term perspective that is a characteristic of family firms. Outsiders have a more moderate presence during this first phase of the firm's life; this is unsurprising, given that the company equity is in the hands of a small number of people, who are properly represented on the board. It therefore appears that the outsiders have been selected appropriately for performing their function. Moreover, in our sample, they have a significantly smaller level of ownership than outsiders in family firms run by subsequent generations; this also gives them a more objective perspective, since they have fewer ties to the firm and therefore perform the work of monitoring and control of management properly, resulting in greater levels of performance.

When the firm is run by second and subsequent generations, the presence of outsiders has exactly the opposite effect on performance. The greater presence of outsiders on the board, the more negative their effect on performance. At first sight, this might seem surprising, given that as the various generations succeed and the share base becomes more diverse, the presence of outside directors may become more necessary to ensure that the interests of the different shareholders are properly represented and that no decisions are taken that are detrimental to the interests of minority shareholders. The results, however, suggest that in such cases outsiders are probably not acting in this way. If we analyse the board composition in firms run by second and subsequent generations, we see that they have an ever greater presence but their stake in the ownership of the firm also increases. In addition, the criteria for choosing directors also vary, and personal friendship plays a very relevant role. One might therefore consider that outsiders –and in particular independents– may not be acting objectively, given their many overlapping interests with the firm. This may explain why their presence on the board results in a drop in performance.

6.- Conclusion

Our aim is to analyze the usefulness of the board of directors as an internal control mechanism and, in the case of family firms, also consider the generational effect. To test our hypothesis that outside directors moderate conflicts between opposing groups in the firm, we examined the relation between firm performance and board composition in family and non-family firms. Moreover, contrary to most previous studies, we did not focus on large listed companies but adopted a sample that includes mainly SMEs, none of which is listed. In an ownership concentration context, we used a sample of 586 non-financial Spanish firms, of which 217 are non-family firms and 369 family firms.

Our findings show the existence of a negative impact of outside directors on firm performance in family firms. The presence of outside directors can be said not to have resulted in improved firm performance. Despite the greater monitoring capacity attributed to outside directors, the firms in the sample showed a significant presence of insider directors, an aspect that may be related to their greater knowledge of the firm, with a subsequently positive effect on strategic planning decisions.

It is also important to note the clear difference in behaviour between family firms run by the first generation and those that are run by subsequent generations. In this case, the presence of outsiders on the board has a positive effect on performance when the firm is run by the first generation. When the firm is run by second and subsequent generations, the presence of outsiders has exactly the opposite effect on performance. The greater presence of outsiders on the board, the more negative their effect on performance. Thus, one might therefore wonder how independent they really are. Taking into account the

means by which they are usually selected -friendship is a very important criterion-, there are grounds for doubting their true independence.

Our paper contributes to the literature on the impact of board composition on firm performance. The contribution of this article is twofold. First, our findings provide a new perspective on the role that outside directors play in corporate governance of family firms. Besides examining the board's role in controlling the manager shareholder agency problem, we also consider the role of the boards in mitigating moral hazard conflicts between shareholder groups with diverging interests in family firms. Second, our research shows that agency theory can be used to explain the role of outside directors in mitigating moral hazard conflicts between shareholder groups with diverging interests in first generation family firms. Third, previous studies (Anderson and Reeb, 2004) focus on relatively large publicly-traded family firms (S&P 500). Nevertheless we focus on SMEs non-listed firms because their findings may not extend to smaller firms. Smaller firms tend to have less public scrutiny than larger firms, indicating independent directors potentially play an even larger role in minimizing agency conflicts (Anderson and Reeb, 2004).

Our research has some implications for family business owners and all those consultants. In family firms run by the first generation, the presence of outside directors has a positive effect on firm performance, while in family firms run by subsequent generations the effect is negative. These results suggest that first generation firms' outside directors' influence is an important element in monitoring family activity. However, when the firm is managed by subsequent generations, there is no such oversight, so we think that the problem can be the criteria for choosing directors. In our sample, personal friendship plays a very relevant role and it might therefore consider that outsiders –and in particular independents– may not be acting objectively, given their many overlapping interests with the firm. Therefore, outside directors are to be selected carefully in order to be adequately qualified to carry out the responsibilities, general knowledge about business management and its environment and knowledge of the peculiarities of the family business.

It is also interesting that the consultants recommend firms to have a well-balanced equilibrium between outside and inside directors because of the important and concrete role they play on it, exercising a more effective function on the board, leading to better performance.

This research has to deal with some limitations. First, the great difficulty to obtain non-listed firms database, and this is even more difficult in the case of family firms. Second, our data are cross-sectional in nature and therefore, we can not clearly infer on causality. Only a panel data sample will allow testing and complementing our findings.

Third, data were collected exclusively in Spain, therefore limiting the possibility of generalizing our findings. Fourth, our analysis focuses solely on the formal independence of the board and ignores the social and psychological factors that may exist between the family and directors.

To conclude, some ideas about future research are pertinent. First, a research design based on longitudinal data would be more suitable for this kind of study in order to increase the reliability of causality directions. Second, we also want to consider the effect of CEO duality in conjunction with founding family ownership and the effect of the size of board of directors in monitoring and control activity. Third, a similar study could be conducted in countries other than Spain in order to increase the validity of our result.

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Notes

Note 1. A collection of Corporate Governance codes of the EU can be found in http://ec.europa.eu/internal_market/company/docs/corpgov/corp-gov-codes-rpt-part1_en.pdf

Table. 1 – Descriptive statistics of sample firms: Mean values for variable measures

	Family Firms	Non-family Firms	Sig.
Number of observations	369	217	---
Number of business segments	2.47	1.36	0.000***
Fraction of single-segment firms	63.60	88.46	---
Board of Director’s composition (Outsiders %)	37.48	35.43	0.549
Insider ownership (%)	50.17	33,10	0.000***
Board of Director’s size (Number of directors)	5	6	0.001***
Return on Assets (%)	6.42	6.41	0.876
Growth opportunity (Sales0/Sales-1)	1.14	1.11	0.753
Leverage (Total Debt / Total Assets)	61.98	64.47	0.122
Firm’s size (Total Assets)	27309.48	63835.39	0.000***
Firm’s age (years)	40	33	0.000***

This table provides descriptive statistics for family and non-family firms. *** ,** and * indicate significance at 1%, 5% and 10%.

Table. 2 - Correlation Data

Variables	1	2	3	4	5	6	7	8
1 Outsiders	1							
2 Insider ownership	-0.384***	1						
3 Board size	0.254***	-0.164***	1					
4 ROA	-0.033	0.051	-0.067	1				
5 Growth opportunity	-0.058	0.042	-0.012	0.234***	1			
6 Leverage	-0.059	0.055	0.037	-0.301***	-0.002	1		
7 Firm’s size	-0.034	-0.010	0.079	0.072	0.014	0.060	1	
8 Firm’s age	0.054	-0.015	-0.018	-0.062	0.002	0.051	-0.054	1

*** Correlation is significant at the 0.01 level

Table 3.- Relationship between the board composition and firms performance in family and non-family firms

	ROA			
	I	II	III	IV
Constante	0.1861 (0.1058)	0.2199** (0.1037)	0.1602 (0.1114)	0.0314 (0.0618)
OUTSIDERS	-0.0179 (0.0235)	0.0197 (0.0271)	-0.0471* (0.0268)	-0.0217** (0.0134)
OUTSIDERS*FD		-0.0567*** (0.0220)		
OUTSIDERS*GEN				0.0647*** (0.0179)
INSOWN	0.0080 (0.0166)	0.0177 (0.0166)	0.0204 (0.1822)	0.0085 (0.0101)
BOARDSIZE	0.0012 (0.0144)	-0.0038 (0.0142)	0.0031 (0.0158)	0.0013 (0.0104)
GROWTHOP	0.6548*** (0.2005)	0.7403*** (0.1986)	0.4992** (0.2534)	0.2165** (0.1011)
LEV	-0.1486*** (0.0450)	-0.1584*** (0.0441)	-0.1017** (0.0473)	-0.1085*** (0.0219)
SIZE	-0.0021 (0.0054)	-0.0033 (0.0053)	-0.0020 (0.0060)	0.0059 (0.0035)
AGE	0.0047 (0.0104)	0.0046 (0.0102)	0.0058 (0.0104)	-0.0032 (0.0058)
F value	1.86	2.33	2.21	3.99
R2	0.19	0.24	0.21	0.20

***, ** and * indicate significance at 1%, 5% and 10%. Models I and II contains the entire sample. Models III and IV refers only to family firms.