FIRM PERFORMANCE AND BOARD OF DIRECTORS STRUCTURE: EVIDENCE FROM SPANISH NON-LISTED FIRMS[1]

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ABSTRACT

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. 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 behaviour 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. BOARD COMPOSITION AND FIRM PERFORMANCE: SOME NOTES ON THEORETICAL BACKGROUND

Board structure and its impact on firm behaviour is one of the most debated issues in corporate governance research. 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, as boards of directors provide a key monitoring function in dealing with agency problems in the firm (Fama, 1980; Jensen, 1993). Thus, agency theory is used to examine the role that the board of directors may play in contributing to the performance of corporate governance (Jackling and Johl, 2009), and to explain 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 monitoring function of boards of directors must focus on reducing the agency problem between disperse shareholders and management (Hermalin and Weisbach, 2001). In companies with high ownership concentration, the controlling shareholders have sufficient incentive, power and information to control top managers (Jensen and Meckling, 1976), so it reduces monitoring costs and boosts

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profitability (Morck et al., 1988; Anderson and Reeb, 2003). In this context, the agency conflict is between controlling and minority shareholders (Lefort and Urzua, 2008). 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).

Some scholars suggest that conflicts between controlling and minority shareholders may 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 ultimate reduce profitability (DeAngelo and De Angelo, 2000; Gómez-Mejía et al., 2001). 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. 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, furthermore, 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., 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, but with different structure and characteristics to those of non-family firms.

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.

2. BOARD COMPOSITION AND FIRM PERFORMANCE: HYPOTHESIS DEVELOPMENT

The agency theory approach is adopted for the examination of board composition in this study. Agency theory implies that adequate monitoring mechanisms need to be established to protect shareholders 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 as a result of their more independent monitoring (Fama an Jensen, 1983; Shleifer an Vishny, 1997). This paper focuses on a similar question, but within non-listed firms with high ownership concentration 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):

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

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.

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

The generational phase of the family firm can be linked to the need for board control. 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).

H3: *The relationship between the proportion of board outside directors of non-listed family firms and firm performance is bigger in family firms run by subsequent generations*

3. EMPIRICAL RESEARCH: METHOD, DATA AND ANALYSIS

3.1. POPULATION AND SAMPLE

This study is conducted 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. The sample under study comprised 3723 non-listed Spanish firms.

In this study, we accordingly classify a firm as a family firm if the main shareholder is a person or a family with a minimum of 20% (La Porta et al., 1999) 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. 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.

Table. 1 - Definition and calculation of variables

4. RESULTS AND DISCUSSION

In our first regression we examined the influence of outside directors on firm performance. Our results show a nonsignificant relationship (β_1 = -0.0179) between outsiders and firm performance. Thus, firm value seems to be insensitive to board composition. 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 Hermalin and Weisbach (1991); De Andres 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.

Table 2.- Relationship between the board composition and firms performance in family and non-family firms

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), we introduce an interaction term between family firms and outsiders. We can see that in the case of non-family firms, although the coefficient of the proportion of outsiders is positive (β_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. The results show a negative relationship between the percentage of outsiders on the board and firm performance like studies of Agrawal and Knoeber (1996).

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 ($\beta 1 + \beta 2 = 0.043$).

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.

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. The results, however, suggest that in such cases outsiders are probably not acting in this way. 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.

5. CONCLUSIONS

This study makes several important contributions to management research. Our findings show the existence of a negative impact of outside directors on firm performance in family firms. 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.

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Table. 1 - Definition and calculation of variables

PANEL A VARIABLES OBTAINED FROM THE QUESTIONNAIRE	
VARIABLE	**DEFINITION**

Generation managing the firm (GEN)	Dummy variable that takes the value of 1 if the firm is headed by the first generation and 0 otherwise.
Board of Director's composition (OUTSIDERS)	Percentage of external directors on the total number of directors
(BOARDSIZE)	Ln Total members on the board of directors.
Insider ownership (INSOWN)	Percentage of ownership of insider directors and chief executive officer
Family Dummy (FD)	Dummy variable that takes the value 1 if the firm complies with the definition adopted and 0 otherwise
PANEL B VARIABLES OBTAINED FROM FINANCIAL STATEMENTS	
Firm performance, measured by firm profitability (ROA)	EBIT / TA, where EBIT = earnings + financial expenses + tax benefit, and TA = Total Assets
Growth opportunity (GROWTHOP)	$Sales_0/Sales_{-1}$.
Debt (LEV)	Total Debt / Total Assets.
Firm's size (SIZE)	Ln Total Assets.
Firm's age (AGE)	Ln number of years of the firm
SECT	Dummy variables to control for sector

Table 2.- Relationship between the board composition and firms performance in family and non-family firms

	ROA			
	I	II	III	IV
Constante	0.1861	0.2199**	0.1602	0.0314
	(0.1058)	(0.1037)	(0.1114)	(0.0618)
OUTSIDERS	-0.0179	0.0197	-0.0471*	-0.0217**
	(0.0235)	(0.0271)	(0.0268)	(0.0134)
OUTSIDERS*FD		-0.0567***		
		(0.0220)		
OUTSIDERS*GEN				0.0647***
				(0.0179)
INSOWN	0.0080	0.0177	0.0204	0.0085
	(0.0166)	(0.0166)	(0.1822)	(0.0101)
BOARDSIZE	0.0012	-0.0038	0.0031	0.0013
	(0.0144)	(0.0142)	(0.0158)	(0.0104)
GROWTHOP	0.6548***	0.7403***	0.4992**	0.2165**
	(0.2005)	(0.1986)	(0.2534)	(0.1011)
LEV	-0.1486***	-0.1584***	-0.1017**	-0.1085***
	(0.0450)	(0.0441)	(0.0473)	(0.0219)
SIZE	-0.0021	-0.0033	-0.0020	0.0059
	(0.0054)	(0.0053)	(0.0060)	(0.0035)
AGE	0.0047	0.0046	0.0058	-0.0032
	(0.0104)	(0.0102)	(0.0104)	(0.0058)
F value	1.86	2.33	2.21	3.99
R^2	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.