OUTSIDERS AND GENERATIONAL PHASE IN FAMILY FIRMS

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ABSTRACT

This paper analyzes the effect of the presence of outsiders on the board of directors on firm performance in family SMEs, highlighting the generational effect. For this purpose we have distinguished between first, second and subsequent generation family firms. Our findings show a converse U-shaped relationship between the proportion of outsiders on board and firm performance for first and second generation family firms. This result demonstrates the existence of an optimal level of outsiders in the board. An appropriate combination of inside-outside directors more effectively contributes to better performance of the firm than excessive outsiders. The optimal level of outsiders in second generation family firms with respect to first generation ones is lower. These findings can be explained by two underlying opposing generational evolutions, namely the lower increase in task conflict among the family members than the rise in family experience and knowledge.

Key words: Outside directors, generation, SMEs, family firms

1. INTRODUCTION

In recent years corporate governance is one of the topics that has received increased attention in management literature, more of them focusing on firm´s corporate governance structures. The implementation of good functioning governance mechanisms, such as a board of directors, has been recognized beneficial by academics and professionals for the growth and development of firms.

The vast majority of these papers focus on analyzing the board of directors' characteristics and their influence in management, strategies and performance of firms. The majority of these studies have focused on large public firms instead in private small and medium sized firms (SMEs) -most of them family firms-, the predominant form of business in the world economies (Corbetta and Montemerlo 1999; IFERA 2003).

In this paper we focus on boards of directors in family small and medium sized firms by investigating the impact of outside director on family firm performance. There are few studies that have explored the contribution of outside directors in the context of SMEs,

and those who do it have adapted concepts and theories developed for large corporations, in many cases only based on the agency theory.

With reference to family firm research, although in recent years efforts have focused on identifying the characteristics of family firm governance systems (Schulze et al. 2001, 2003; Anderson and Reed 2003, 2004; Lane et al. 2006; Miller and Le Breton-Miller 2006; Van den Heuvel et al. 2006; Villalonga and Amit 2006), there is fairly little knowledge about the relationship between the generation in charge of the firm and its corporate governance. Voordeckers et al. (2007) and Bammens et al. (2008) analyse the effect of generational phase on the existence of an outside board, considering service and control roles of the board but not the resource dependence perspective.

This paper analyzes the effect of the presence of outsiders on the board of directors on firm performance in family SMEs, highlighting the generational effect. For this purpose we have distinguished between first, second and subsequent generation family firms. Following Johnson et al. (1996), we considerate service, resource dependence and control roles. To test our hypotheses, we examined the relationship between firm performance and the proportion of outside directors on the board. Moreover, contrary to most previous studies, which analyze listed firms, we focus on family SMEs because the findings of large firms may not extend to smaller ones.

Our findings show a converse U-shaped relationship between the proportion of outsiders on board and firm performance for first and second generation family firms. This result demonstrates the existence of an optimal level of outsiders in the board. An appropriate combination of inside-outside directors more effectively contributes to better performance of the firm than excessive outsiders. So, inside directors provide a deep and specific knowledge about the firm and this fundamental knowledge for strategic decision making, and outsiders increase the firm's legitimacy in its environment and improve relationships with relevant stakeholders, besides the control role, which is far less prominent.

The optimal level of outsiders in second generation family firms with respect to first generation ones is lower. These findings confirm the greater knowledge acquired by insiders in second generation family firms, and the increase of their experience and personal networks. These results suggest a significant decrease in the need for complementary outside know-how from the first to the second generation, which is not likely to be compensated by the increased need for outside arbitration.

This study makes several contributions to the literature on the impact of board composition on firm performance. These results provide a new perspective on the role

that outside directors play in corporate governance of family firms. Moreover, examining the board's role in controlling the conflicts between shareholder groups, we also consider the advice and counsel and resource dependence role of the board. Besides, our research shows that the composition of the board changes because its needs are different depending on the generation running the firm. The bulk of empirical research on the role and effect of outside directors on firm performance has however mostly been conducted on large publicly held companies. There consequently seems to be deficiencies in our knowledge of the role and contribution of outside directors in SMEs.

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 OF DIRECTORS AND FIRM PERFORMANCE: THEORICAL BACKGROUND AND HYPOTHESES

Researchers studying corporate governance have used a diverse set of theoretical perspectives to understand the characteristics, roles, and effects of boards of directors (Finkelstein and Hambrick 1996, Corbetta and Salvato 2004; Voordeckers et al. 2007; Pieper et al. 2008).

The role and contribution of outside directors in SMEs seem to vary depending on the theoretical framework used, and the type of firm being studied (Gabrielson and Huse 2005). The concept of an outside director is not generic and should not be used interchangeably without reflections of what the consequences will be. Much of the corporate governance research proceeds from the assumption that the composition of the board influences the effectiveness with which directors perform these roles (Finkelstein and Hambrick 1996, Johnson et al. 1996).

The most important duties of the board can be described in terms of three overlapping roles: service, resource dependence and control (Johnson et al. 1996). In the service role, directors advise managers on administrative and management issues, help to formulate strategies and augment the firm's image and reputation through directors' own professional accomplishments (Zahra and Pearce 1989). In the resource

dependence role, directors acting as representatives of specific institutions facilitate the acquisition of external resources that are important to the firm's success (Pfeffer 1973). The control role consists basically in the monitoring of firm corporate financial performance. The directors exercise control over managers so that they act in the best way to protect the interests of shareholders (Fama and Jensen 1983; Minichilli et al. 2009).

The framework suggests that various theories -agency theory, resource based theory and resource dependence theory- can be applied to different kinds of SMEs through expectations about the role (control, providing advice and counsel, and managing resource dependencies) and characteristics (independence, expertise, boundary spanner) of outside directors (Gabrielson and Huse 2005). But it is not necessary to choose one theoretical perspective over another. The literature review indicates the importance of using multiple theories for understanding this issue. Indeed, one can obtain a better understanding of family business boards of directors by trying to integrate different theoretical perspectives rather than choosing among them (Minichilli et al. 2009).

Board structure has relied heavily on agency theory concepts, focusing on the control function of the board (Hillman and Dalziel 2003; Fama and Jensen 1983; Jensen and Meckling 1976). Agency theory treats the company as a nexus of contracts through which various participants transact with each other (Jensen and Meckling 1976). Agents are opportunistic and are strongly motivated to take profit from the information asymmetry between them and their principals. This theory asserts that management and ownership pursue different interests, where top managers may be more interested in their own personal welfare than that of shareholders (Jensen and Meckling 1976). 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). Outside directors is expected to monitor management's self-interest more effectively than inside directors.

However, the agency problem seems less important in the context of family firms with high ownership concentration, given that the controlling shareholders have sufficient incentives, power and information to control top managers (Jensen and Meckling 1976). The strong alignment of interests between owners and managers reduces agency costs arising from the need to establish mechanisms for the supervision of the management

team. (García and García 2010). Fama and Jensen (1983) contend that family management is especially efficient.

However, high ownership concentration can trigger other problems with corporate governance and other types of cost. Asymmetric altruism, free-rider problems and family members' entrenchment could cancel or even exceed the benefits derived from the agency agreement between owners and managers (Schulze et al. 2001, 2003, Chua et al. 2009). CEOs can support their families, giving them privileges they would not have if they did not belong to the family. Agency problems and relations in family firms seem to have a different origin than usual agency relationships in nonfamily firms (Voordeckers et al. 2007). Schulze et al. (2003) propose that family relations tend to make agency problems associated with private ownership and owner management more difficult to resolve due to self-control and other problems engendered by altruism. Thus, without management supervision new agency costs arise (García and García, 2010).

Nevertheless, the parental altruism that characterizes agency relations that arise in these organizations promotes feelings of loyalty, trust and commitment among family members and facilitates communication, all of which reduces agency costs (Bartholomeusz and Tanewiski 2006; Lubatkin et al. 2005).

Research has shown that agency problems can exist in family firms (Gomez-Mejia et al. 2001; Schulze et al. 2001). Chrisman et al. (2007) indicate that family firms make liberal use of both incentive compensation and monitoring mechanisms on family managers and using monitoring and incentive compensation results in a better performance. The results are in line with Schulze et al. (2001) who indicate that monetary incentives improve family firm performance.

The main contribution of outside directors according to agency theory is consequently their ability to be independent when overseeing operating matters, protecting the assets of the firm, and holding managers accountable to the firm's various key stakeholders to ensure the future survival and success of the enterprise (Gabrielson and Huse 2005). Outsiders have the obligation to ensure that management operates in the interests of shareholders, an obligation that is met by scrutiny, evaluation and regulation of the actions of top management by the board (Hillman and Dalziel 2003). This task consists basically in the monitoring of firm corporate financial performance (Minichilli et al. 2009). Boards with a majority of outside directors are believed to be more effective in the control role because the directors of such boards may be less amenable to the CEO's influence (Johnson et al. 1996).

Besides agency theory, several other theoretical perspectives have been used in order to explain the composition of the board of directors. According to Resource based theory, a firm's internal environment, its resources and capabilities, is critical for creating sustainable competitive advantage (Prahalad and Hamel 1990; Teece, et al. 1997). Knowledge is an intangible resource that can sustain a competitive advantage in the long term and one way to enhance its acquisition is involvement in firm ownership. Family members tend to develop their career within the family business, enabling them to attain positions of responsibility more easily than in other organizations. Small firms are however generally characterized by a lack of internal resources, and in-house knowledge may in many cases be scarce or non-existing (Storey 1994). It becomes very important the advisory role of the board (Daily and Dalton 1993), as they can provide comprehensive and complementary outside knowledge that can be used by the management team in formulating and implementing their strategies (García and García, 2010).

The board of directors, and especially the outside directors, may hence be considered as a bundle of strategic resources to be used by and within the small firm as they can provide timely advice and counsel to the CEO and the management in areas where in-firm knowledge is limited or lacking (Gabrielson and Huse 2005).

The appearance of outside directors on the board of small private firms will reflect the service and resource needs of the CEO (Whisler 1988) rather than the control role (Fiegener et al. 2000). The resource based view consequently recognize that can be a valuable source of competitive advantage through their professional and personal qualifications (Gabrielson and Huse, 2005).

Thus, the outside director is an experienced person on whom the CEO and the dominating family members trust, its appearance on the board is often in direct response to the needs of the CEO for counsel and specific expertise (Whisler 1988), and the knowledge and skills of outside directors may complement, or compensate for, those of managers and internal directors (Huse 1990).

Nevertheless, a board made up entirely of outside directors could not efficiently develop this role given their lack of experience and knowledge on key aspects of the firm and its environment, to which is added the difficulty of acquiring this necessary knowledge (Ford, 1992). Insiders are those who have a deep and specific knowledge about the firm (Pfeffer and Salancik 1978). The boards of directors perform a service task and are supposed to bring different types of resources to the firm (Minichilli et al. 2009).

The outside board members are in this respect seen as a linking mechanism between the firm and its environment that may support the managers in the achievement of the various goals of the organization (Zahra and Pearce 1989). Among the different potential benefits provided by corporate boards, external legitimacy and networking are considered to be particularly valuable (Hillman and Dalziel 2003).

Outside directors increase a firm's legitimacy in its environment (Johnson et al. 1996; Zahra and Pearce 1989) and to improve relationships with relevant stakeholders (Pfeffer and Salancik 1978). These directors are known and powerful persons that take profit of their personal networks in order to increase the legitimacy, the reputation and the stock of resources controlled by the company (Pfeffer 1973; Pfeffer and Salancik 1978).

Small firms tend to have fewer alternatives for managing their resource dependencies (Pfeffer and Salancik 1978). A critical factor of growth within small and medium-sized family firms is the access to external financing sources. From a resource dependence perspective it is clear that an outside director can fulfil the boundary spanning role by directly or indirectly helping small and medium-sized enterprises in accessing the external financing market. Boards that have more outsiders can help firms to connect with a greater variety of external resources (Pfeffer 1973). Therefore the board's resource dependence role may take on added importance in small firms (Daily and Dalton 1993). Also, outside directors can be an effective means for overcoming the human resource limitations that often plague small firms (Huse 1990, Daily and Dalton 1993). Therefore, resource dependency theory recognizes that outside directors may add value to SMEs by helping to initiate and maintain control over critical relationships, assets and contacts in the external environment of the firm (Gabrielsson and Huse, 2005).

Agency theory and resource dependence theory indicate that outside directors exhibit a positive relation to firm performance, but the role of the board of directors is different in each theory. Under agency, outsiders monitor and control insiders and/or the family. Under resource dependence theory, outside directors had a well-developed personal and business network that could mediate trust, reduce internal resource dependencies, and establishing links between internal and external stakeholders. According resource based theory, outside directors could not efficiently develop the service role given their lack of experience and knowledge, so the insiders facilitate the transfer of information between the board and the management team.

In short, an appropriate combination of outside and inside directors may be the best composition for a board. Family firm boards should be characterized by a difficult

balance between outsiders and insiders, the shareholders should prefer boards that include a mixture of well-informed inside directors and outside directors, but with outsiders in the majority, because such boards offer the best overall performance of all three roles (Fiegener et al. 2000)

This observation led us to hypothesize that the relationship between the proportion of outsider directors and firm performance is nonlinear in non-listed family SMEs. More specifically, we propose that the relationship is inverted U-shaped.

H_1: There will be an inverted-U-shaped relationship between the proportion of board outsiders directors of non-listed family firms and firm performance.

The generational phase can be linked with the board composition. One of the main contributions of boards in family firms is the provision of advice, counsel, resource dependence and control. Changes in the level of family experience and conflict can affect the need for board network, advice and arbitration. As recent literature points out (Voordeckers et al. 2007; Baamens et al. 2008) the generational stage of the business mediates the relationships between board task needs and board composition, so we expect board composition to adjust to this situation.

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. Reductions in agency costs may be achieved by entirely eliminating the separation between owners and management. In such cases, the interests of principal and agent are aligned and it is assured that the management will not expropriate the shareholders' wealth (Miller and Le-Breton Miller 2006).

As a family firm prepares to incorporate later generations, priorities and problems change (Gersick et al. 1997). The family property is shared by an increasingly large number of family members, 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). When more family members are active in the firm, the likelihood of opposite opinions and objectives increases, thereby increasing the need for outside arbitration (Voordeckers et al. 2007). Families age and a new generation takes over the key management positions in the firm, the risk of intra-family conflict augments (Schulze et al. 2003). Davis and Harveston (1999, 2001), found more conflict as subsequent generations run the firm.

Consequently, 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).

Conflicts between family members generate the need for board control to ensure that the management team considers the preferences and interests of all family owners (Bammens et al. 2008). The new generations family managers may be viewed as being exclusively concerned with the interests of their own nuclear household rather than the interests of the entire extended family (Raskas 1998; Lubatkin et al. 2005). Sibling partnerships often require the installation of formal governance mechanisms to control employed siblings and this can be considered even more important for the cousin consortium generational stage (Steier 2001; Lubatkin et al. 2005), so subsequent generations run the firm the need for outside arbitration takes place.

In contrast, a significant body of research suggests that the characteristics of organizations such as board composition are dependent upon the education of senior managers. In subsequent generations, the level of education and knowledge of the family firm members increase and it is expected to be related to board composition (Finkelstein and Hambrick 1996).

Knowledge and family experience in the business tend to increase over generations. The value of internal executive directors for the advisory board role increases with the generational stage of the company (Bammens et al. 2008).

A higher generation can be a proxy for a well-developed internal knowledge base in the firm. Higher generation successors are often better educated than the first generation owner-manager. Therefore, the need for external advice and counsel decreases (Voordeckers et al., 2007). As the level family experience of organizational knowledge develops over the generations (Astrachan et al. 2002; Miller and Le Breton-Miller 2006), the need for personal network and complementary know-how held by outside directors should decrease .

The board in small and medium-sized family firms is a resource through its insiders with a higher level of education are more likely to partly substitute for network, counselling and advising activities due to increased cognitive abilities. Consequently, the likelihood that outsiders or nonfamily managers are employed as director is lower.

As the result of the above mentioned, the generational phase will influence on the proportion of outsiders on the board. Therefore, the final result of the relationship between firm performance and the presence of outsiders depends on which of the effects dominates. If the increased knowledge, family experience and cognitive abilities of inside directors exceed the increased need for outside arbitration, our hypothesis is:

H2a: The optimum level of outsiders on the board decreases over generations.

Otherwise, if the increased need for outside arbitration exceeds the increase in inside directors' knowledge, family experience and cognitive abilities, our hypothesis is:

H2b: The optimum level of outsiders on the board increases over 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 2958 non-listed Spanish firms.

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. We established 50% as the minimum percentage of a firm's equity considered as a controlling interest (Voordeckers et al. 2007; Westhead and Howorth 2006). To find compliance with these two conditions, we conducted an exhaustive review of shareholding structures (percentage of common stock) and composition (name and surnames of shareholders), and also examined the composition of the board of directors of each 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 50% 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.

After sending a reminder or contacting the firm by phone, 369 family firms responded the questionnaire 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 12.47%, 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 composition of the board.

Table. 1 - Definition and calculation of variables

PANEL A VARIABLES OBTAINED FROM THE QUESTIONNAIRE	
VARIABLE	**DEFINITION**
Generation managing the firm (GEN1)	Dummy variable that takes the value of 1 if the firm is headed by the first generation and 0 otherwise.
Generation managing the firm (GEN2)	Dummy variable that takes the value of 1 if the firm is headed by the second generation and 0 otherwise.
Generation managing the firm (GEN3)	Dummy variable that takes the value of 1 if the firm is headed by the third and subsequent generations and 0 otherwise.
Board of Director's composition (OUTSIDERS)	Percentage of external directors on the total number of directors
Board of director´s size (BOARDSIZE)	Ln Total members on the board of directors.
Insider ownership (INSOWN)	Percentage of ownership of insider directors and chief executive officer
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

4. RESULTS

The relation between firm performance and the independent variables is examined through an OLS regression. Table 2 presents descriptive statistics for the variables in the analysis. We show mean values for family firms in the sample. It should be noted the significant proportion of outside directors in family firms´ boards. These boards have a composition which, at first sight, seems efficient in order to maintain family firm

interests represented and separated. The evolution of this composition tends to reduce the presence of insider directors in favour of outsiders as subsequent generations run the firm. It is therefore necessary to determine the possible effect the presence of outside directors might have on firm performance due to the different roles they can play. In relation to *control variables*, it can be highlighted the high insider ownership, due to the CEO's percentage of ownership, which is, on average, 50.17%. It is also noteworthy that family firms have an average age of 40 years, suggesting that our firms are well established.

Table. 2 – Descriptive statistics of sample firms: Mean values for variable measures

	Family Firms		
Number of observations	369		
Board of Director's composition (Outsiders %)	37.48		
	1st Gen	**2nd Gen**	**3rd Gen**
% insiders	74.39	68.58	51.99
% outsiders	25.61	31.42	48.01
Control variables			
Insider ownership (%)	50.17		
Board of Director's size (Number of directors)	5		
Return on Assets (%)	6.42		
Growth opportunity ($Sales_0/Sales_{-1}$)	1.14		
Leverage (Total Debt / Total Assets)	61.98		
Firm's size (Total Assets)	27309.48		
Firm's age (years)	40		

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

	ROA			
	I	II	III	IV
Constante	0,193	0,041	0,176**	0,168**
OUTSIDERS	-0,191	-0,40	-0,085	-0,218
$OUTSIDERS^2$	0,119	0,028	0,087	0,212
OUTSIDERS*GEN1		0,235***	0,304***	0,437***
$OUTSIDERS^2$*GEN1		-0,218***	-0,298***	-0,424**
OUTSIDERS*GEN2			0,135**	0,268**
$OUTSIDERS^2$*GEN2			-0,178**	-0,303**
OUTSIDERS*GEN3				0,155
$OUTSIDERS^2$*GEN3				-0,140
INSOWN	0,018	0,007	0,006	0,006
BOARDSIZE	0,004	-0,002	-0,003	-0,004
GROWTHOP	0,263**	0,217**	0,324***	0,310***
LEV	-0,117***	-0,109***	-0,105***	-0,109***
SIZE	-0,001	0,005	-0,001	-0,001
AGE	0,001	0,005	0,003	0,004
F value	1,68	4,09	4,63	4,25
R^2	0,12	0,18	0,23	0,19

*** ,** and * indicate significance at 1%, 5% and 10%.

Our study conducts further tests to examine the possibility of nonlinearity between firm performance and the board composition. So an inverted-U-shaped relationship is expected.

The results are shown in Table 3. In our first regression we examined the influence of outside directors on firm performance without considering the generation running the firm (column I). A negative coefficient is found for outsiders variable (β_1 = -0.191) and a positive coefficient for its square (β_2 =0.119), but neither is significant. These results do not allow us to confirm whether there is a nonlinear or inverted-U-shaped relationship between the proportion of board outside directors of non-listed family firms and firm performance. Therefore, we cannot accept hypothesis 1.

In order to fulfill the following objectives of the research we compare the behavior of family firms as subsequent generations run the firm and we can see different results (column II, III and IV). First, we test whether there are significant differences in the optimal board structure of this group of companies based on their generational stage, we included three variables interactively to indicate which generation is running the firm (first generation, second generation and third and subsequent generations). To corroborate the relationships suggested by this model of interactive effects, we conducted another analysis (not reported) in which the sample was divided into first, second and subsequent generation family firms. The results are similar.

The Hypothesis 2a predicted that the optimum level of outsiders on the board increases over generations and Hypothesis 2b predicted that the optimum level of outsiders on the board decreases over generations.

For first generation family firms the results are the expected. The coefficient is positive and significant (β_3 = 0.235, column II) and its square is negative and significant (β_4 = -0.218, column II), so the results exhibit an inverted-U-shaped relationship because the coefficients β_3 and β_4 are significantly positive and negative, respectively. This result demonstrates the existence of an optimal level of outsiders in these firms, which stands at around 51%. From this level a new outside director worsens the performance of the firm, which supports the argument that an appropriate mix of insider and outside directors is the better composition. The firm performance increases with a higher proportion of outsiders, and from this level, the firm performance decrease.

With respect to second generation family firms, the significance and sign of the variables (β_4 = 0.304 and β_5 = -0.298, column III), positive and negative respectively, confirms the existence of a non-linear relationship with performance in this generation family firms. The optimal level of outsiders in these firms stands at around 38%, in

contrast with the 51% found for the first generation. These results confirm that the generational phase will influence on the proportion of outsiders on the board. The optimum level of outsiders decreases for second generation family firms. The increased knowledge, family experience and cognitive abilities of inside directors exceed the increased need for outside arbitration.

Nevertheless, for third and subsequent generation family firms, the coefficient are positive and negative (β_6 = 0.155, and β_7 = 0.140, column IV), but they are not significant. The results exhibit no relation between the proportion of outsiders on the board and firm performance. These findings contrast with the data in Table 2, in which we can see the proportion of outsiders on the board increases with the generation. The higher proportion of outsiders is not related with a better firm performance. One possible reason is the implementation of the recommendation of good governance. This finding also leads us to question whether outside directors really comply with the condition of independence with respect to the company and its members.

5.- DISCUSSION

We do not find any robust relationship between outsiders and firm performance, thus, Hypothesis 1 was not supported. These results are partially consistent with those obtained for other types of firms by authors such as Klein (1998), 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 order to fulfill the next objective of this research, we analyze the influence of the generation running the firm on board composition.

For first generation family firms the results confirm a non-linear relationship with performance. This result demonstrates the existence of an optimal level of outsiders in the board, which stands at around 51% and shows that in first-generation family firms the presence of outsiders, must have a limit. This result can be explained based on the roles that outside directors seem to play in family firms (Voordeckers et al. 2007). An appropriate combination of inside-outside directors more effectively contributes to better performance of the firm than excessive outsiders. In these firms outside directors, due to their personal networks, increase the firm's legitimacy in its environment and improve relationships with relevant stakeholders, besides the control role which is far less prominent. However, the presence of outsiders on the board has a limit. The information and knowledge provided by inside directors to the board are particularly important in achieving better performance in family firms, whereas knowledge and

experience of family directors contribute to the effective performance of the advisory function. García and García (2010) found similar findings for a sample of listed firms.

Nevertheless, if we analyze second generation family firms, our findings show an inverted U-shaped as well, but the cutoff point is around 38%. These findings confirm the hypothesis 2a if we compare first and second generation family firms. We postulate that the optimum level of outsiders on the board decreases over generations. This findings can be explained by two underlying opposing generational evolutions, namely the increase in task conflict among the family members and the rise in family experience and knowledge (Davis and Harveston 1999; 2001; Klein et al. 2005). The lower optimal level of outsiders with respect to first generation family businesses, consistent with Bammens et al. (2008), can be due to greater knowledge acquired by members of the family over generations, successors are often better educated in the second generation (Voordeckers et al. 2007), the increase of family experience (Klein et al. 2005), cognitive abilities and the increase of the insider´s network. Insiders are known and more powerful persons that take profit, and this increase the legitimacy, reputation and the stock of resources controlled by the firm. Therefore the need for external knowledge, advice, counsel and personal networks decrease, thus the need of outsiders is lower, which exceed the increased need for outside arbitration. In second generation the family property is shared by an increasingly large number of family members and conflicts may start to arise when the interests of the family members are not aligned. Following Voordeckers et al. (2007), in this stages in which agency problems are high, family firms do not seem to cope with these agency problems through the employment of outside directors.

Finally, for third and subsequent generation family firms, we found no relationship between the presence of outsiders on the board and firm performance, so the presence of outside directors is not significant for these family firms. These results do not allow us to establish the optimum level. 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 it would be interesting to examine the degree of independence and specific expertise held by the outside directors on the board. One might suspect that the criteria for choosing directors also can vary, and personal friendship could play a relevant role. This may result in lack of real power and potential to contribute more extensively to the

firm's strategy (Brunninge et al. 2007). One might therefore consider that outsiders may not be acting objectively, given their many overlapping interests with the firm.

6. CONCLUSIONS

This paper analyzes the effect of the presence of outsiders on the board of directors on firm performance in family SMEs, highlighting the generational effect. For this purpose we have distinguished between first, second and subsequent generation family firms. To test our hypotheses, we examined the relationship between firm performance and the proportion of outside directors on the board. Moreover, contrary to most previous studies, which analyze listed firms, we focus on SME family firms, none of which is listed. In an ownership concentration context, we used a sample of 369 family firms.

Our findings show a converse U-shaped relationship between the proportion of outsiders on board and firm performance for first and second generation family firms. This result demonstrates the existence of an optimal level of outsiders in the board, which stands at around 51% in first generation and 38% in second generation. An appropriate combination of inside-outside directors more effectively contributes to better performance of the firm than excessive outsiders. So, inside directors provide a deep and specific knowledge about the firm and this fundamental knowledge for strategic decision making, and outsiders increase the firm's legitimacy in its environment and improve relationships with relevant stakeholders, besides the control role, which is far less prominent.

The optimal level of outsiders in second generation family firms with respect to first generation ones is lower. These findings confirm the higher concern about the greater knowledge acquired by insiders in second generation family firms, and the increase of their experience and personal networks. These results suggest a significant decrease in the need for complementary outside know-how from the first to the second generation, which is not likely to be compensated by the increased need for outside arbitration.

Our results also shed light on prior seemingly contradictory and puzzling evidence concerning the impact of board composition on firm performance over the different generations. First, these results provide a new perspective on the role that outside directors play in corporate governance of family firms. Examining the board's role in controlling the conflicts between shareholder groups, we also consider the advice and counsel and resource dependence role of the board. Second, our research shows that the composition of the board changes because its needs are different depending on the generation running the firm. Third, the bulk of empirical research on the role and effect of outside directors on firm performance has however mostly been conducted on large

publicly held companies (Daily et al. 1998; Anderson and Reeb 2004; Jaskiewicz and Klein 2007; Pieper et al. 2008; Wang and Oliver 2009; García and García 2010). There are consequently few studies that have explored the role and contribution of outside directors in the context of SMEs family firms (Voordeckers et al. 2007; Arosa et al. 2010) and those who do have often uncritically adapted concepts and theories developed for large firms. There consequently seems to be deficiencies in our knowledge of the role and contribution of outside directors in SMEs. We focus on family SMEs because the findings of large firms may not extend to smaller ones.

Our research has some implications for family business owners and all those consultants. The outside directors can play multiple roles in SMEs. Our results suggest that first and second generation firms' outside directors' influence on firm performance, these directors certainly can add value to the firm. In these firms outside directors, due to their personal networks, increase the firm's legitimacy in its environment and improve relationships with relevant stakeholders, besides the control role which is far less prominent. However, the presence of outsiders on the board has a limit. The information and knowledge provided by inside directors to the board are particularly important in achieving better performance in family firms, whereas knowledge and experience of family directors contribute to the effective performance of the advisory function. So, it is interesting that the consultants and accountants of the firm, who fulfil the legal obligations related to the annual meetings of the board of directors, 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. It is recommended that family firms incorporate outside directors on the board, but, considering our findings, with a limit.

However, when the firm is managed by third and subsequent generations outsiders do not add value to the firm, so we think that the problem can be the criteria for choosing directors. The reports show that outside directors in family firms tend to have strong ties to the CEO and/or the dominating family members. Their independence can therefore be questioned.. Personal friendship could play 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. Outsider selection is important because must give professionalism to the board. Therefore, outside directors are to be selected carefully in order to be adequately qualified to carry out the responsibilities. Outsiders must have skills, experience in other family businesses, know corporate

management, separation from family members and their respect and economic independence on the compensation they receive.

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, we don´t know the importance that the CEO gives to the different roles that board can have, since, for example, in family SMEs the control role may be less important that theory predicts. Third, data were collected exclusively in Spain, therefore limiting the possibility of generalizing our findings.

To conclude, some ideas about future research are pertinent. First, in this paper we analyze the effect of the presence of outsiders on the board of directors on firm performance in family SMEs, highlighting the generational effect. A next step will be to analyze the influence of the different board task on the relationship between the generational phase and board composition. Second, a similar study could be conducted in countries other than Spain in order to increase the validity of our result.

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