CORPORATE GOVERNANCE, WEAK INVESTOR PROTECTION AND FINANCIAL PERFORMANCE IN SOUTHERN EUROPE

Rebeca García-Ramos
Department of Business Administration, University of Cantabria, Spain
Assistant Professor of Finance
garciarr@unican.es

Myriam García Olalla
Department of Business Administration, University of Cantabria, Spain
Full Professor of Finance

Abstract

The effectiveness of boards of directors is addressed in a context of weak legal protection using a sample of listed firms from Southern. A cross-country and panel data design is used, taking into account the endogeneity problem arising in studies of corporate governance. The results show that there is an inverted U-shaped relationship between independent directors and firm performance which allows us to identify the optimal level of independent directors on the board. Moreover, the study determines whether there are significant differences in the optimal level of independent directors depending on the family identity of the large shareholder and whether any such differences are correlated with firm performance. This article has implications for practitioners because the results fail to support good the governance recommendation suggesting that more independent directors are always in the best interest of investors.

Key Words: corporate governance, independent directors, weak investor protection, large family shareholders, performance, endogeneity.

JEL Classification: G30, G32, G38

1. INTRODUCTION

In last decades, several recommendations with regard to board structure for public corporations have been made and written into codes of good governance. A common theme is the agency theory perspective, which seeks to strengthen the role of monitoring boards. The emphasis of these codes on the monitoring function of boards is aligned with the focus of agency theory in much of the literature on boards of directors. However, related empirical evidence is inconclusive, and there is limited guidance for policymakers seeking to identify

governance practices that result in more effective firm performance (Finegold et al., 2007).

A key aspect of firm governance is ownership structure, including the typology of the firm's shareholders (Shleifer and Vishny, 1997; Villalonga and Amit, 2006). In this paper we determine the optimal level of independent directors on the board, a feature of the structure of boards that have been identified as central to the development of good corporate governance in organisations. Moreover, we test whether there are significant differences in the optimal level of independent directors when the large shareholder is a family. Data from the Southern European business sector enable us to analyse the impact of corporate governance on firm performance in a context in which large shareholders are common and a significant number of firms are controlled by family groups.

2. HYPOTHESIS DEVELOPMENT

Following Hillman and Dalziel (2003), we consider that boards of directors serve two important roles: monitoring the management on behalf of shareholders and providing resources.

Whether independent directors have an impact on firm performance is one of the most debated and researched areas of corporate governance, although empirical evidence offers no conclusive results. There is some evidence of a positive relationship (e.g., Baysinger and Butler, 1985), a negative relationship (e.g., Bhagat and Bolton, 2008) and a nonsignificant relationship (e.g., Hermalin and Weisbach, 1991) between these two variables. In an attempt to explain these conflicting findings, Dalton et al. (1998) conducted meta-analyses of the research on board composition and performance and did not find evidence of a link between independent directors and firm performance.

Agency theory (Jensen and Meckling, 1976) implies that adequate monitoring mechanisms need to be established to protect shareholders from management's opportunistic behaviours which maximize their own self-interests. From this perspective, those who most effectively engage in monitoring on boards are independent directors due to the few conflicts of interest they face (Dalton et al., 1999). Thus, if the monitoring function takes precedence over the provision of resources, we expect a positive relationship between company performance and board independence.

Independent director appointments can also be relevant to the provision of resources by the board because such directors can provide comprehensive and complementary outside knowledge (mostly based on university training and

outside work experience) that can be used by management teams in formulating and implementing strategies (Daily and Dalton, 1993). Nevertheless, a board made up entirely of independent directors could not efficiently work in this capacity because it would lack experience with and knowledge of key aspects of the firm and its environment and would have difficulty acquiring this necessary firm-specific knowledge (McVey et al., 2005). Executive directors spend their working lives at the company they help to direct, so they are a valuable source of experience with business operations and firm-specific knowledge related to the functioning of the company. This experience makes them able to provide resources efficiently (Donaldson and Davis, 1994; Raheja, 2005). Executive directors also facilitate the transfer of information between the board and the management team. As a result, proponents of stewardship theory contend that superior corporate performance will be linked to a high ratio of executive directors to independent directors because the former naturally work to maximise profit for shareholders.

Because maximising firm performance requires a board to perform effectively in all areas (Baysinger and Butler, 1985), we expect that an appropriate mix of executive and independent directors may be best for a board. We have formulated our hypothesis as follows:

Hypothesis 1: There is an inverted u-shaped relationship between independent directors and firm performance.

A large family shareholder can exercise control by controlling its board of directors and/or by assuming the executive functions of board members (Bammens et al., 2010). Large family shareholders are less likely than nonfamily investors to incorporate independent directors into their boards (Schulze et al., 2001). The first reason for this is that family owners associate a loss of control and discretion with independent directors. The second is that although independent directors may improve the provision of external resources, they have little influence on decision making involving family members. Moreover, if controlling families are motivated to expropriate minority shareholders, they will have an incentive to limit monitoring by any independent directors they appoint. Thus, large family shareholders tend to choose directors who are not truly independent (because they have a friendly or contractual relationship with the company), therefore compromising board independence (Lane et al., 2006).

Moreover, scholars identified stewardship theory as potentially being highly applicable to the realm of large family shareholders, characterized by involvement-oriented management philosophies, strong firm identification, low

reliance on institutional powers, and personal and social fulfilment (Anderson and Reeb, 2003; Miller and Le Breton-Miller, 2006). From this perspective, any form of direct or indirect control may lower stewards' motivation, negatively affecting their pro-organisational behaviour. Therefore, we expect independent directors to be less effective in their monitoring role in those firms which have a large family shareholder.

In addition, close ties to agents do encourage the provision of resources by boards (Hillman and Dalzield, 2003). Compared with non family shareholders, family managers are said to have an advantage with regard to firm-specific knowledge (Bammens et al., 2010), and they have been associated with specific dynamics in terms of knowledge management transmission (Cabrera-Suárez et al., 2001). Family managers tend to guard their privacy and to be very careful in choosing those with whom they share confidential information. Thus, it is expensive to transfer specific knowledge about the company to independent directors and executives are preferred (Lane et al., 2006).

Bearing in mind the arguments presented above, we expect the presence of a large family shareholders to influence the relationship between independent directors and firm performance. Therefore, we have formulated the following hypothesis:

Hypothesis 2: The effect of independent directors on firm performance will be different in firms which have a large family shareholder.

3. RESEARCH METHODOLOGY

3.1. Sample and variables

The empirical analysis conducted is based on a sample of non-financial, publicly traded firms from Spain, Portugal and Italy during the 2001-2007 period. We chose these countries because they are framed within the tradition of *French Civil Law*, and thus, both the ownership concentration and the proportion of family controlling shareholders tend to be higher than in countries whose legal systems originated from *Common Law* due to the lower level of protection of shareholder interests in the former (La Porta et al., 1999).

We constructed a database based on information provided by the supplier Bureau Van Dyjk, the stock market regulators, the stock exchanges and the company websites. We only included firms with an ultimate owner[1](García-Ramos and

[1] Because our aim was to obtain a sample that was as homogeneous as possible and would thus allow us to link the differences found to the identity of the controlling shareholder and not to the level of concentration of property rights. We used control chain methodology to identify firms´ owners (La Porta et al., 1999). We considered a company to have an ultimate owner if the main shareholder directly or indirectly held a percentage of sahres greater than or equal to 25%. On

García-Olalla, 2011). For a business to qualify as a family firm, we required family members not only to control at least 25% of property rights[2] but also to be actively involved in the control and/or management of the firm. Correspondingly, we divided the sample into two groups, those own and controlled by a family and those with a nonfamily large shareholder. After we had applied necessary filters[3], the number of companies included in the sample was 212, 34% were own-controlled by a family.

VARIABLES	DEFINITION
	DEPENDENT
Q: Firm performance	Market-to-book value ratio (Q)[4]: the book value of total assets minus the book value of common equity plus the market value of common equity divided by the book value of total assets as the usual proxy for Tobin's Q.
	INDEPENDENT
Independent directors	The number of independent directors divided by the total number of directors on the board of each company.
Independent directors²	We included the square variable for *independent directors* to test for the existence of the inverted u-shaped relationship proposed in our hypothesis.
	CONTROL[5]
Lag Q	The lag value of Tobin´s Q.
Firm size	Natural logarithm of the total value of assets
Firm debt	Quotient between total debt and assets
Firm age	Natural logarithm of the number of years since the firm's constitution
Year$_x$	Dummy variables (value of "1" when the sample observation corresponds to year "x" and "0" otherwise)
Country$_y$	Dummy variables (value "1" when the firm belongs to country "y" and "0" otherwise)
Sector$_z$	Dummy variables (value "1" when the firm belongs to sector "z", and "0" otherwise)
	INTERACTIVE
Family	Dummy variable that takes the value "1" if the firm is own-controlled by a family and "0" otherwise

the basis of these criteria, all of the firms in our sample have a concentrated ownership structure.

[2] We chose this threshold for two reasons. First, whereas the existing literature on the USA used levels of 10% and 20%, we tried to adjust to the more concentrated ownership structures of most European countries. Second, we sought to maintain consistency with the official definition of a family business in Europe as approved in 2008 by two international institutions representing family businesses, the European Group of Owner Managed and Family Enterprises (GEEF) and the Board of the Family Business Network.

[3] We only included those firms for which information was available on all of the variables considered for a sufficient number of years according to the econometric technique used. We needed available data for at least five consecutive years within the 2001-2007 period to test the second-order serial correlation (Blundell and Bond, 1998), which is fundamental to guaranteeing the robustness of the estimations made via the GMM System methodology.

[4] It is common in corporate governance literature on the use of this or similar measures as the dependent variable (Andrés et al., 2005; Cheng, 2008; Jackling and Johl, 2009).

[5] Control variables that influence firm value are included to avoid any bias in the results, consistent with prior studies of corporate governance and performance (Andrés et al., 2005; Cheng, 2008; Jackling and Johl, 2009).

Table 1 shows the descriptive statistics for the full sample.

Table 1: Descriptive statistics

Variable	Min	Max	Mean	Std. Dev.
Q-Tobin	.10	16.20	1.41	1.06
Independent directors	.00	1.00	.31	.21
Firm size	6.32	20.56	13.66	2.44
Firm debt	.02	1.00	.61	.20
Firm age	.00	5.04	3.28	.95

3.2. Model estimation

The econometric approach used to test our hypotheses is panel data, which allows us to account for individual unobservable heterogeneities between different companies and to eliminate the risk of obtaining biased results. To address the endogeneity problem that arises in our analysis, we used the generalised method of moments system estimator (Blundell and Bond, 1998).

Using the above methodology and in order to test hypothesis 1, we proposed a model that explained company performance in accordance with the explicative variable related to the board of directors and the control variables considered. To determine to what extent the relationship between independent directors and firm performance is affected by the family identity of the large shareholder (hypothesis 2), the moderator variable *family* was introduced in the model interactively. The estimated model is as follows:

$$Q_{i,t} = \beta_0 + \beta_1\ INDEPENDENT\ DIRECTORS_{it} + \beta_2\ (INDEPENDENT\ DIRECTORS_{it} \times FAMILY) + \beta_3\ INDEPENDENT\ DIRECTORS_{it}^2 + \beta_4\ (INDEPENDENT\ DIRECTORS_{it}^2 \times FAMILY) + \beta_5\ LAG\ Q + \beta_6\ FIRM\ SIZE_{it} + \beta_7\ FIRM\ DEBT_{it} + \beta_8\ FIRM\ AGE_{it} + (YEAR_\tau + COUNTRY_i + SECTOR_i + \eta_t + \nu_{it})$$

Additionally, and in order to find the optimal level of board independence in our sample, we derive the optimal level of independent directors at which the firm performance is maximized. To that end, we solve for the first derivative of performance with respect to independent directors

4. ANALYSIS AND RESULTS

The results of the model estimations are reported in Table 2. The joint Wald tests of the overall statistical significance of the model confirm the validity of our model (876.36 with $p<.001$). The AR2 tests confirm the absence of second-order

serial correlation[6] (-.70 with p>.1). Finally, the Hansen tests confirm the validity of the instruments we used to avoid the endogeneity problem (38.82 with p>.1).

Table 2. Results of the panel data regression model

Dependent variable: Tobin's Q	
(Constant)	1.810 ***
Independent directors	.908 **
Independent directors x Family ownership structure	-1.410 **
Independent directors^2	-1.886 ***
Independent directors^2 x Family ownership structure	1.992 ***
Lag Q	.420 ***
Firm debt	.103
Firm size	-.048 **
Firm age	-.098 **
$Year_x$(6)	Yes ***
$Country_y$(2)	Yes *
$Sector_z$(7)	Yes ***
Tests of significance:	
YEAR –test	64.70 ***
COUNTRY –test	3.44 *
SECTOR –test	63.18 ***
Z_1 –test	1.65 *
Z_2 –test	.63
JOINT F-test	876.36 ***
Instruments validity test:	
Hansen	38.82 (.478)
Autocorrelation test:	
AR(1)	-2.42 (.015)**
AR(2)	-.70 (.485)

* p<.1; ** p<.05; *** p<.01. Yes: inclusion of dummy variables. YEAR –test: Wald test of the joint significance of the year's dummy variables; COUNTRY –test: Wald test of the joint significance of the countries' dummy variables; SECTOR –test: Wald test of the joint significance of the sector's dummy variables. Z_1-test: Wald statistic for the linear restriction test under the null hypothesis H_0: $\beta_1+\beta_2=0$ [H_0: independent directors+(independent directors x family ownership)=0]. Z_2-test: Wald statistic for the linear restriction test under the null hypothesis H_0: $\beta_3+\beta_4=0$ [H_0: independent directors^2+(independent directors^2 x family ownership)=0]. JOINT F-test: F test of the joint significance of the variables in the model, under the null hypothesis of lack of relationship. Hansen: over-identifying restriction test, distributed as a chi-square under the null hypothesis of no relation between the instruments and the error term. AR(1) and AR(2) are the second order serial correlation statistic using residuals in first differences, under the null hypothesis of non-serial correlation.

Our model allows us to identify the effect of independent directors on firm performance for the two subgroups of firms under consideration, those owned and controlled by a family and those with a large non-family shareholder[7]. The effect

[6] Given the use of first-difference transformations, we expected some degree of first-order serial correlation (test AR1), and this correlation does not invalidate our results. However, the presence of second-order serial correlation does signal omitted variables.

[7] The coefficients for each subgroup are the result of the sum of the coefficient for the direct variable plus the moderator effect: *direct variable + (direct variable x family)*. The dummy variable *family* takes the value 1 for family own-controlled

of independent directors on firm performance is non-linear. The positive and significant coefficient of the variable *independent directors* (β_1=.908 and p<.05) and the negative and significant coefficient of the variable independent directors^2 (β_3=-1.886 and p<.01) confirm that there exists an inverted U-shaped relationship between independent directors and firm performance as stated in *hypothesis 1*.

The moderator terms show that the incremental effect for family own-controlled firms with respect to firms with a large nonfamily shareholder is negative and significant for *independent directors* (β_2=-1.410 and p<.05) and positive and significant for *independent directors*^{2} (β_4=1.992 and p<.01). Therefore, the relationship between independent directors on the boards and firm performance depends on the family nature of the large shareholder. This result allows us to accept *hypothesis 2*. For family own-controlled firms the coefficients of *independent directors* ($\beta_1+\beta_2$=.908+(-1.410)=-.502), which the Wald-tests show to be significant (Z_1=1.65 and p<.1), and independent directors^2 ($\beta_3+\beta_4$=-1.886+1.992=.106), which the Wald-tests show to be non-significant (Z_2=.63 and p>.1), indicate that the effect of independent directors on firm performance is negative.

With the estimated coefficients we optimally derive the breakpoint at which the relation between independent directors and firm performance turns from positive to negative in firms with a large nonfamily shareholder[8]. The optimal level of independent directors that maximizes firm performance is 24.07%.

Our results are robust to the inclusion of control variables. We find that whereas the effects of *firm size* and firm age on firm performance are negative, the effect of *firm debt* is not significant. Year, country and sector effects are also significant.

5. CONCLUSIONS

Our study highlights the different role played by independent directors depending on the identity of the large shareholder of the firm. The inverted u-shaped relationship between board independence and firm performance found in firms with a large nonfamily shareholder reinforces the argument that an adequate combination of executives and independent directors is better than excessive

firms and 0 otherwise. The coefficients of the direct variables therefore represent the effect of independent directors on the performance of firms with a large nonfamily shareholder. The coefficients of the moderator effects include the incremental effects of each board variable (*independent directors* and *independent directors*^{2}) on the performance of family own-controlled firms with respect to the reference group, those with a large nonfamily shareholder. The coefficient for family owned-controlled firms equals the sum of the coefficient for firms with a large nonfamily shareholder plus the moderator effect.

[8] Because the effect of independent directors^2 on firm performance is not significant in family own-controlled firms, we cannot derive the breakpoint.

independence as a means of helping firms achieve better performance. On the other hand, the adverse effect of independent directors on the performance of family own-controlled firms indicates the lower effectiveness of independent directors in terms of monitoring and providing resources in the presence of large family shareholders. With regard to large family shareholders, consistent with stewardship theory, capital markets appear to view more insiders on the board as positive. When the presence of independent directors has a negative effect, this may simply suggest that there are more independent directors than is optimal, which would prevent the expected positive relationship from being empirically observed. One possible reason that boards may continue to be allowed excessive independence is that good governance recommendations essentially advocate this.

These results force us to reconsider and reshape the empirical links traditionally evidenced in the financial literature between performance and independent directors in widely held firms because this study contradicts the widespread belief that more independent boards are always more effective. Although recommendations regarding governance mechanisms are based on agency settings, this research show that where there is a large family shareholder, stewardship theory-based governance mechanisms lead to better corporate performance. Indeed, less independent boards are tied to better performance by the family own-controlled firms in our sample.

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