The board structure and firm performance in SMEs: Evidence from Spain

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ARTICLE INFO

Article history:
Received 6 September 2012
Accepted 14 December 2012
Available online 9 February 2013

JEL classification:
G3

Keywords:
Board composition
Board size
SME
Duality
CEO tenure

ABSTRACT

The aim is to analyse the efficiency of the board of directors as a corporate governance mechanism. For this purpose, we examine the effect of board composition, size, activity, leadership structure and CEO tenure on firm performance. To test our hypothesis we use a sample of 307 Spanish SMEs, none of which is listed. Our main empirical result is the negative impact of the outside directors proportion and board size on firm performance. The presence of outside directors can be said not to have resulted in improved firm performance. Despite the greater monitoring, advising and networking 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. The negative effect of board size could indicate that the disadvantages of worse coordination, flexibility and communication inside large boards seem to be more important than the benefits of better manager control by the board of directors.

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La estructura del consejo y la rentabilidad empresarial en las PYMEs: evidencia desde España

RESUMEN

El objetivo es analizar la eficiencia del consejo de administración como mecanismo de gobierno corporativo. Para ello, analizamos el efecto de su composición, tamaño, actividad, estructura de liderazgo y mandato del máximo ejecutivo sobre los resultados empresariales. Para contrastar las hipótesis utilizamos una muestra de 307 PYMEs españolas, ninguna de las cuales cotiza en Bolsa. Nuestro principal resultado es el efecto negativo de la proporción de consejeros externos y tamaño del consejo sobre los resultados empresariales. Se puede decir que la presencia de consejeros externos no se traduce en la mejora de los resultados de la empresa. A pesar de la mayor capacidad de control, asesoramiento y creación de redes atribuida a los externos, las empresas de la muestra presentan una significativa presencia de consejeros internos, aspecto que puede estar relacionado con su mayor conocimiento de la empresa, con el consiguiente efecto positivo en las decisiones estratégicas de la misma. El efecto negativo del tamaño del consejo puede indicar que las desventajas de la poca coordinación, flexibilidad y comunicación dentro de los consejos de gran tamaño, parecen ser más importantes que los beneficios derivados del mayor control gerencial por parte del consejo.

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1. Introduction

The efficiency of corporate board as a central institution in the internal governance of a company and its impact on firm behaviour is one of the most debated issues in literature today. Literature on boards focuses on three main questions (John & Senbet, 1998): the size of the board (Barroso Castro, Villegas Periñán, & Pérez-Calero, 2010; De Andrés, Azofra, & López, 2005; Eisenberg, Sundgren and Wells, 1998; García-Olalla & García-Ramos, 2010; Jackling & Johl, 2009; Jensen, 1993; Yermack, 1996); its composition and
independence (Arosa, Iturralde, & Maseda, 2010; Barroso Castro et al., 2010; Bhagat & Black, 2000; De Andrés et al., 2005; García-Ollala & García-Ramos, 2010; Jackling & Johl, 2009; Lefort & Urzúa, 2008); and its internal structure and functioning (De Andrés et al., 2005; García-Ollala & García-Ramos, 2010; Jackling & Johl, 2009; Klein, 1998; Vafeas, 1999).

This paper adds to this empirical literature by analysing the influence of the board activity (number of meetings), leadership structure and CEO tenure as well as the size of the board and its composition on firm performance. Besides, in the context of non-listed firms, this paper studies specifically the efficiency of board of director in small and medium-sized firms.

Most research on corporate governance and boards has focused theoretically and empirically on large corporations (Daily, Dalton, & Canella, 2003; Gabrielson & Huse, 2004). However, the literature identifies both differences and similarities in corporate governance and boards in large and small firms (Machold, Huse, Minichilli, & Nordqvist, 2011). While agency problems are also relevant to the small firm context, decision-making and control structures here are less complex and diffuse compared to large firms resulting in a comparatively diminished boards’ monitoring role (Daily & Dalton, 1993; Fama & Jensen, 1983). Owners of small firms may be more concerned about firm survival, growth rate, family welfare, succession plan, personal status, etc. than retaining short-term financial returns that are a core concern of shareholders in public companies. The different focuses of interests may affect how boards perform their tasks (Pugliese & Winstrup, 2007). The type and content of boards’ tasks also vary between small and large firms (Zahra & Pearce, 1989). Effective governance of small firms also depends on the firm’s capability of tapping board knowledge (Pugliese & Winstrup, 2007). Finally, the impact of founders and/or key entrepreneurs on boards and governance may be greater in small firms compared to large ones (Arthur, Busenitz, Hoskisson, & Johnson, 2009).

We conducted, following Johnson, Daily, and Ellstrand (1996), an integrated analysis of three functions of the board of directors, supervisory, advisory, and monitoring with particular emphasis on the impact that its structure, composition and size has on firm performance. Our main empirical result is the negative impact of the outside directors proportion and board size on firm performance. The presence of outside directors can be said not to have resulted in improved firm performance. Despite the greater monitoring, advising and networking 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. The negative effect of board size indicate that the disadvantages of worse coordination, flexibility and communication inside large boards seem to be more important than the benefits of better manager control by the board of directors.

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 and their discussion are presented in Section 4. We conclude the paper in Section 5 with some conclusions and implications for management theory and practice, as well as the limitations of the investigation. The paper ends with a list of bibliographical references.

2. Theoretical background and hypotheses

In recent years the attention and interest in corporate governance structures has grown significantly in management literature, especially after the financial corporate collapses happened around the world. Various published Codes of good governance have made recommendations on the size of the board, its composition, and the internal or external character of its directors. The aim is to establish effective control over the management of the firm by the board of directors and its responsibility for the firm and the shareholders.

However, governance studies have focused on large public firms instead of private small and medium sized firms (SMEs).

The interest of SMEs’ researchers has been concentrated on the need to identify the existence of governance mechanisms to guarantee the survival of SMEs.

This paper focuses on the link between firm performance and several corporate governance issues such as the composition of the board, its size, its activity, its leadership and its tenure in non-listed SMEs.

2.1. Board composition

Among the different dimensions of board of directors, board composition is one of the most debated issues 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 Andrés et al., 2005). Most of the corporate governance codes developed at the country level an international level (e.g., Sarbanes-Oxley Act in US, Combined Code in UK, Conthe Code in Spain, OECD Code) require boards of directors 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 & Jensen, 1983; Shleifer & Vishny, 1997). Support for the agency theory, scholars has suggested alternative explanations for the determinants of board composition. So, Hermelin and Weisbach (1998), Raheja (2005), Harris and Raviv (2008), and Adams and Ferreira (2007), model the theoretical determinants of board composition, specifically the roles of insiders and outsiders (Linck, Netter, & 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. A growing body of research suggests that a strong and vigilant board of directors can have a significant positive influence on the value-creating potential of SMEs by favouring change and innovation in strategic decision-making (Gabrielson, 2007a). In small firms there may be problems with inconsistent information between managers and shareholders due to vague divisions of responsibilities and the absence of formal reporting systems. Also, the markets for corporate and managerial control may function less well in these kind of firms (Gabrielson & Winlund, 2000). Medium-size companies can be expected to benefit from the external supervision that a governing board can offer, for example by providing attention to critical issues facing the company and directing the company towards appropriate competitive strategies by allocating resources to innovative projects and procedures necessary for responding to changes in the marketplace (Gabrielson, 2007a). Hermelin 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

Theorem 1: There is a significant positive relationship between the size of the board and its composition and the internal or external character of its directors. The aim is to establish effective control over the management of the firm by the board of directors and its responsibility for the firm and the shareholders. However, governance studies have focused on large public firms instead of private small and medium sized firms (SMEs).
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