The Relationship of Board Composition to Company Performance in Small and Medium Sized Family Firms: A Theoretical Model

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Prior research has investigated the role of board composition and company performance in larger firms. Little research, however, has investigated this relationship in smaller, family owned firms. This research examines the literature on board composition and strategic decision making, and presents a theoretical model for board composition and firm performance in small and medium sized family firms. Specifically, this paper proposes that an independent board of directors will be positively related with performance in these small and medium sized firms. A proposed methodology for investigating this model and implications are also discussed.

Family owned businesses are important contributors to the U.S. economy, employing over 62% of the nation’s workers and representing upwards of 64% of the GDP (Shanker & Astrachan, 1996; Sharma, 2004). Internationally, family businesses represent the majority of all businesses (IFERA, 2003). They are also key to the social cohesion and stability of many communities (Niehm, Swinney & Miller, 2008).

Despite their economic and social importance, not all family businesses are successful and perform well. In fact, over 70% of these businesses do not make it past the first generation and less than 5% make it to the fourth generation (Beckhard & Dyer Jr, 1983; Ward, 2004). Like many non-family businesses, family businesses have their share of problems. Unique to family businesses are the problems of succession (the passing from one family generation to another) as indicated by Chua, Chrisman and Sharma (2003), as well as family conflict. Family conflict and coalition politics among family members can contribute significantly to the failure of family businesses (Kellermanns & Eddleston, 2004; Kets de Vries, 1993).

One other uniqueness among family firms and in particular, those of the small and medium sized nature, is the composition of the board of directors, if a board actually exists. The purpose of this paper is to examine the relationship between board composition of these types of firms and the firm’s performance and to provide a theoretical basis for board composition and higher performance. This paper begins with a literature review on the purpose of the Board of Directors and their various compositions as they relate to small and medium sized family businesses and how these boards differ from mainstream public company boards. Following this is a description of the research methods that should be used, some guidelines for developing the study, and practical implications of the examination of these differences.

LITERATURE REVIEW

Pursuant to agency theory, the purpose of Board of Directors (BOD) is to provide a formal link between owners and the managers responsible for the day-to-day operations of the firm (Fama & Jensen, 1983). The BOD has the power to hire and fire senior management personnel as well as serving to resolve conflicts of interest between the various decision makers.

Before analyzing the small and medium sized family businesses, let us first very briefly examine the larger public companies and their board structures and look at their effects on performance. With the various accounting scandals such as Enron and WorldCom, and with numerous more companies restating their earnings (Agrawal & Chadha, 2005), there were calls to bring these situations under control. The Sarbanes-Oxley Act, 2002 (SOX) addressed these many concerns and issues. As a result, the BOD composition in many public companies has changed dramatically in the post-SOX era. One of the
Major changes in board composition have been the addition of independent members. Different corporations will have different definitions for what is an independent director. For purposes of this study, an independent director is defined as a person who has no material relationship with the company (including as an employee, partner, shareholder, or officer of an organization that has a relationship with the company).

Several studies have been done linking performance to BOD composition, specifically to a board dominated by independent directors. In a 2005 study, Petra examined the effects that outside independent directors had on firm performance and shareholder wealth (2005). He concluded that independent directors do strengthen corporate boards. Similar studies by Gordon (2007) and Murray (2007) came to analogous results. A BOD dominated by independent directors, it seems, is here to stay. However, a 1998 meta-analytic study by Dalton et al. suggests that there is no relationship between BOD composition and firm performance (Dalton, Daily, Ellstrand & Johnson, 1998). This study was conducted prior to SOX, which may have had an impact on their findings.

The family firm, be it public or private, brings a different set of variables to the table when addressing the composition of the BOD. Family firms can use its member’s assets to strengthen the firm, but alternatively, family members can take assets out of the company, thereby undermining the firm’s stability. Haynes, Walker, Rowe, and Hong (1999) examined the prevalence of a family to use their funds to support the business or if the business's assets were used to fund the family's needs. They found that families were more likely to use the firm's resources to satisfy their needs rather than using personal assets to strengthen the firm.

Behavioral issues or family dynamics also represent a major difference between family firms and non-family firms. Corbetta and Savato (2004) note that “the owning family has a strong influence on virtually all psychological and situational antecedents of organizational behavior” (p. 357). Family cohesion is one component of that behavior. Increased family cohesion can substantially improve company revenues (Olson, Zuiker, Danes, Stafford, Heck & Duncan, 2003).

When it comes to studying the BOD composition and performance levels of the family firms, virtually all of the studies focus on the larger public family firms. Anderson and Reeb (2004) determined that the most valuable public firms were those that were able to balance independent directors with family membership. Their results were consistent with agency theory in that they found that “independent directors act to prevent the misappropriation of the firm’s resources, resulting in better firm performance” (p. 226).

In a 2007 family business study, 788 responses were analyzed from businesses with revenues of at least $5 million and in existence for at least five years (Laird Norton Tyee, 2007). The BOD structure was broken down as follows: 24.9% had no board at all, 61.4% had a board of directors, 7.1% had an advisory board, and 6.6% had both an advisory board and a BOD. Of those companies with boards, 54.2% consisted of family only, 2.1% were non-family only, and 43.7% had both family and non-family members. One other statistic from this study indicated that 23.4% of the respondents either disagreed or strongly disagreed that a BOD makes a positive contribution to the direction of the business. Although not confirmed, it is suggested that this group would be the same group as represented by the 24.9% that had no board at all. A similar study of family businesses conducted in 2002 showed that 87.5% of family businesses had boards of three to four members and that 90.6% had at least 2 family members (Mass Mutual, 2007) 25% of respondents indicated no contribution from a board, which could imply that there was no board present.
As the above statistics would imply, the majority of family businesses do have a BOD of some sort. Most appear to be insider (MassMutual, 2007) dominated, followed by a mix of insider and outsider membership, with businesses having no boards rounding out the field. Why would a company not have a BOD? Most small businesses are started by a sole founder/entrepreneur, and most entrepreneurs value their independence and tend to want to keep 100% control. According to Johannisson and Huse (2000), “Entrepreneurs in particular may defy any definitive control, including that of a formal board” (p. 375). The existence of a BOD or its composition also depends upon the generational position of the business (Bammens, Voordeckers & Van Gils, 2008). Firms in different generational phases will have different governance requirements. A new or young business is still being run by its founder and will have no need for any directional input from anyone.

As seen by the statistics above, an overwhelming majority of family businesses have a Board of Directors. The next question that beckons to be answered is whether to have an outside (independent) dominated board or an insider dominated board. To determine this, it is proposed that each format and its effect on performance should be examined (Brouthers, Brouthers & Werner, 2003). The measures of performance that should be used are sales growth, sales level, profitability, market share, reputation, distribution, market rating and market access. The earlier definition of an independent director did not account for the family business environment. Therefore, any family member not active in the business cannot be considered as an independent director.

Just as in the larger public family business, the addition of outside directors can have a positive effect on the business. The presence of an “active, effective board of outside directors” can be one of the single greatest resources for a family business (Aronoff & Ward, 1992, p. 62). Outside directors can provide the necessary objectivity needed to help with a number of issues, such as dividend policy, compensation and familial support. Aronoff and Ward (1992) also suggest that many successions probably would not have been executed without the presence of the outside board member. “The mere presence on the board of respected outsiders signals a commitment by the owners to employees who may be uneasy about the owners’ intentions of keeping the business or of remaining interested in the business.” (Ward, 1988, p. 224). Fiegener, Brown, Dreux, and Dennis Jr. (2000) found that an outside board would more likely be present when the business was closer to succession than not, and also when the business would chose a non-family member as its successor. In the same study, it was also determined that ownership held by individuals outside the business was the strongest determination of an outside board makeup. The CEO would adopt an outside board when external owners demanded it. Both the BOD and the top management team can have an effect on the productivity of the small firm, both family and non-family (Cowling, 2003). The addition of an outsider non-executive was found to positively impact productivity output. Productivity was also correlated to a larger board size as well.

An outside dominated BOD can have a positive influence if there is an honest desire on the part of the CEO to have such a board, if there is a selection process that assures the competence of such a board and if there are shared expectations (between management and the board) about the contributions to be made by such a board. The typical family-owned business has a concentrated shareholder base and family member insiders active in both management and the board of directors (Lane, Astrachan, Keyt & McMillan, 2006). Many studies have been done from the management perspective to determine whether, overall, this is a positive attribute for the family business or whether it negatively impacts the business (Carney, 2005; Poza, Hanlon & Kishida, 2004).

Small businesses tend to be less strategic when the ownership structure is more controlled than widespread (Bruninge, Nordqvist & Wiklund, 2007). Given the fact that past research (Sharma, Chrisman & Chua, 1997) establishes the connection between strategic planning and the success of the family business, it would stand to reason that family businesses that are more “insider” controlled would not be as successful as their counterparts.
Van den Heuvel, Van Gils, and Voordeckers (2006) determined that most CEO’s of SME’s found their boards to be more useful in a service role (reputational resource, networking, etc.) than in a control role (determining management’s roles, salary, etc.). This suggests that the management team would have more of an impact on performance than would the BOD. Bruninge, Nordqvist, and Wiklund (2007) also endorses the concept that the top management team has more impact than does the BOD. A Turkish study (Kula & Ekrem, 2006) found that the weight of the outside director’s on a board was the least prevalent attribute to company performance. In another study, Westhead and Howorth (2006) also determined that ownership structure was secondary to management as they relate to firm performance. Finally, Sciacia and Mazzola (2008) found that family involvement in ownership has no effect on firm performance. Based upon this evidence, the following proposition is posited:

**Proposition 1:** A Board of Directors that is predominately independent will have a positive impact on the performance of a family business.

**METHODOLOGY**

As this study is concerning itself with small and medium sized, private family firms, typically collecting data from these firms is potentially difficult to obtain (Handler, 1994). Private firm owners are usually reluctant to release financial data as well as other information as it pertains to their performance and company operations. Previous studies involving these types of companies have, however, obtained the necessary information and data. This can be accomplished using either primary or secondary data. Secondary data can come from studies such the Mass Mutual study or the Laird Norton Tyee study, both of which were referenced earlier. However, the use of secondary data can limit the validity of the study due to the necessary data not being available as it relates to the variables in this study. Therefore, the preferred data source would be primary. Databases, such as Compustat, WRDS, D&B, or organizations such as the Small Business Administration or the Family Firm Institute can be used to gather a sample size sufficiently large enough from which to draw data. Once a sample size of firms has been identified, a questionnaire will be developed and distributed to that sample, probably through some sort of online survey, similar to Qualtrix. The F-Pec scale (Astrachan, Klein & Smyrnios, 2002) should be incorporated into the questionnaire to ensure the respondents consisted of family-owned businesses. This scale has the ability to distinguish between family owned or non-family owned businesses. It is anticipated that a sample size of at least 100 is needed to conduct the appropriate analyses of data.

Firm performance can be more difficult to measure, especially in the private firm arena. Ideally, objective data is preferred, but as mentioned earlier, this data is not freely expended. As a result, subjective data is the alternative choice. Dess and Robinson (1984) confirmed that although objective data is the preferred choice, subjective data was proven to be strongly correlated to objective data. There are two ways to analyze subjective data. Scascia and Mazzola (2008) use eight measures and asked the respondent to compare their performance against their competitors. Alternatively, various studies, such as Brouthers et al. (2003), have used the eight measures (shown in Appendix 1), and found them to be a very successful measure of firm performance. They ask the respondent how satisfied he/she is concerning the eight performance measures and use a 10 point scale ranging from very dissatisfied to very satisfied.

**DISCUSSION AND PRACTICAL IMPLICATIONS**

The practitioner value of this study will serve to further enhance the potential value of independent (outsider) membership on the boards of small family owned businesses. Studies show that in larger, publically owned family businesses, an independent dominated board positively contributes to firm performance. Publically owned firms are scrutinized more closely and are legally bound by more rules
than their smaller private counterparts. Many times these smaller private firms (rightly or wrongly) feel that they do not have much in common with their “big brothers.” This study would help to break down that perception.

Academically, this research will serve to enhance the literature on two counts – the BOD literature as well as the family business literature. As stated earlier, this type of study has been conducted on the larger, publically owned family firms, but not on the smaller private family businesses. This study would, therefore, contribute to the research on the smaller family owned businesses, which tend to dominate the marketplace worldwide. Future research could go further by identifying some moderating factors, such as gender, or age and looking at the family business BOD under those microscopes.

Independent board members can introduce a level of objectivity and accountability, expecting that their voices will be heard. Further, independent board members can contribute to help professionalize the family business as well as help in the formalization of policies and processes such as the succession process. Outside members can provide continuity and guidance to the younger generation coming on board, thereby aiding the preservation of the founder’s (or prior generation’s) vision for the company. Additionally, they can be instrumental in developing potential exit strategies should continuation not be an option.

As family businesses can be prone to differences of opinions and potentially damaging conflicts, outside directors can act as mediators or conflict managers. They can offer a different perspective. They have the ability to help separate family matters from business matters as a result of their neutrality. Their independence allows them to offer constructive criticism without fear of initiating a family squabble.

Lastly, their ability to look into the business from the outside can help the CEO deal with a long term strategy as opposed to being bogged down with the day to day operations. Risk management, future growth, potential investments, and preserving a positive impact on the community are just some of the things that an independent director can positively impact a family business.

**CONCLUSION**

In conclusion, this paper provides a theoretical framework for board composition and strategic decision making. First, it proposes that an independent board of directors will be positively related to small and medium-sized firm performance. Secondly, it provides a methodology for investigating this research model for future research. Finally, it offers both research-based and practical implications for this model. There is great value for external board members on a family-owned firm board, and continued research will demonstrate the benefits of this purposeful board composition.

**REFERENCES**


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**APPENDIX 1**

**FIRM PERFORMANCE MEASURES**

How satisfied are you with the performance of this operation?

<table>
<thead>
<tr>
<th>Sales Growth</th>
<th>1 2 3 4 5 6 7 8 9 10</th>
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<tbody>
<tr>
<td>Sales Level</td>
<td>1 2 3 4 5 6 7 8 9 10</td>
</tr>
<tr>
<td>Profitability</td>
<td>1 2 3 4 5 6 7 8 9 10</td>
</tr>
<tr>
<td>Market Share</td>
<td>1 2 3 4 5 6 7 8 9 10</td>
</tr>
<tr>
<td>Reputation</td>
<td>1 2 3 4 5 6 7 8 9 10</td>
</tr>
<tr>
<td>Distribution</td>
<td>1 2 3 4 5 6 7 8 9 10</td>
</tr>
<tr>
<td>Market Rating</td>
<td>1 2 3 4 5 6 7 8 9 10</td>
</tr>
<tr>
<td>Market Access</td>
<td>1 2 3 4 5 6 7 8 9 10</td>
</tr>
</tbody>
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1 = Very dissatisfied; 10 – Very satisfied