Board Membership Changes and Financial Performance: The Moderating Role of Family Firms

Samy Mesnik
FGV EAESP
Samy.mesnik@gmail.com
Samy.mesnik@fgv.edu.br

Abstract: The aim of this study is to examine a possible relationship of corporate financial performance and board membership changes. As a consequence, whether too little or too much board membership changes would produce a detrimental impact to financial performance. Furthermore, this study investigated whether this effect is more pronounced in family firms over non-family firms. Based on the agency theory and stewardship perspective, the results indicate that board membership changes are significant for family firms towards short-term financial performance indicators, with positive effect above a certain interval, though it signaling to the market may not be relevant. Also provides insightful examination of a specific corporate governance issue that is valuable both for academics and practitioners.

Keywords: Board Membership Changes, Financial Performance, Family Firms, Corporate Governance

1. Introduction

The board of directors represents a crucial internal corporate governance mechanism to validate and monitor managerial decisions in order to protect shareholders (Fama and Jensen, 1983). The incidence of large family ownership, and the incentives that the family attain to benefit from control, raises the question of whether the effectiveness of the board of directors might act as a mechanism to keep the family from expropriating minority shareholders' wealth (Anderson & Reeb, 2004). The tension among board, family and minority shareholders lead to a agency problems, that usually is more prevalent in family firms with Chief Executive Officer (CEO) and Chairperson of the Board (COB) duality (Palanissamy, 2015). That is, when the same individual holds both positions in the company, and under entrenchment circumstances (Randolph et al., 2018), and family-related managers are granted protection against monitoring by the board, dismissal, or punishment for unsatisfactory performance results.

Board membership turnover should be one form of mitigation of such agency problems, in addition to reducing family-specific governance failures (Li and Zuo, 2020). Family owners, when controlling shareholder, should remove board members that fail to fulfill their responsibility and to protect their interests. Notwithstanding, just as CEOs might become entrenched in their positions (Shleifer and Vishny, 1989), directors in family firms can also become entrenched simply because of their family connection (Gonzalez, 2019), even when they are not family members. Apart from other mechanisms to prevent agency problems that are overly costly and time-consuming, such as executive monitoring committees, controlling systems, balance scorecard, compliance and audit departments, this study will concentrate on board's membership change and examine its relation to financial performance.

Empirical literature defends positive and negative effects of board turnover on financial performance and theorical literature explain higher and lower board turnover on family firms, however limited studies examine a non-linear relationship between these factors and explore the effect of family business moderation on this equation. The aim of this study is to investigate whether there is a significant relationship between board membership modifications and financial performance, furthermore, to understand if this effect is different between family firms versus non-family firms. We contribute to agency theory and stewardship perspective by showing the effects of board mechanism changes and the impacts on family firm performance. Using an emerging market, in which most of firms are owned by families and represent more than half of the local GDP (Gross Domestic Product), according to World Bank data, there are few studies that explore this perspective. It was found empirical evidence that family firms perform fewer changes on the board, in proportion to its board size, compared to non-family firms and there is an association between board membership change and financial performance of family firms towards short-term financial performance indicators.

2. Board membership changes and financial performance

According to agency theory in family firms, Chairperson of the Board/Chief Executive Officer (COB/CEO) duality reduces the effectiveness of monitoring activities and could lead to expropriation of firm resources by controlling family members (Liu & Chen, 2016). Generally, without appropriate monitoring, CEOs may abuse their power, put their own interests first and make decisions that are detrimental to the firm (or to the firm's owners), such as hiring incompetent, but with close personal relations, individuals (Combs et al., 2011). Although the segregation or the unification of chair and CEO positions does not impact firm's performance when moderated by family's high ownership, the separation of the two roles is more effective when the family is not entrenched (Braun & Sharma, 2017), indicating that both situations (COB/CEO duality and entrenchment) could negatively affect firm performance (Garcia-Castro & Aguilera, 2014).

Board turnover has been argued to bring both positive and negative impacts to companies. On the one hand, board turnover is believed to lead to more skillful and impartial contributions of the members (Wong and Koh, 2019). Additionally, more shared information increases efficiency in making decisions because members are better able to anticipate and coordinate with each other's actions (Mathieu et al., 2000). Wong and Koh (2019) defend the effectiveness in decision-making that is influenced by any pre-existing bias toward shared task information remains unchanged after director removal. Accordingly, incoming directors may improve effectiveness of information-processing by reducing bias toward shared information in decision-making. Newcomers' inputs should strengthen advisory and monitoring decisions, in cases of prior high percentage of independent directors, because the board has developed better information-processing capacity to embrace new perspectives. Additionally, new directors may possibly be included in respond to pressures for change (Dalton et al., 2006). Anderson and Chun (2014) found that companies that changed three or four directors over a three-year period surpassed their industry peers, suggesting this number as an optimal amount of turnover, across firms in the S&P 500 index. Conversely, the poorest performers were companies with either no director changes at all in three years or else five or more changes. This suggests an inverted U-shaped curve of the impact of board membership turnover on financial performance.

On the other hand, membership changes interrupt the flow of shared information in the company, such as beliefs and about situation of the firm, in a way that may inhibit the board's ability to provide effective advice on complex issues or lead to suboptimal decisions, subsequently linked to poorer firm performance (Wong and Koh, 2019). Another important aspect of elevated board turnover is that incoming directors tend to be downgraded by the longer-tenured directors, for neither possessing in-depth information about the firm nor being employees of the firm. This attitude may reject opinions from the newcomers, favor responses that are familiar, or impede the board to come to a consensus (Rink et al., 2013).

To sum up, literature suggests that few changes on the board could lead to less ideas, preserving the business knowledge of most participants, whereas more changes promote more ideas conceding diminution of depth knowledge about that specific business. Thus, the mechanism through which the changes in board composition might affect the performance is the participants knowledge. Therefore, an optimal point of knowledge exchange should be obtained, so that board membership's change and financial performance is enhanced. Therefore, the following hypothesis is proposed:

Hypothesis 1: The composition of the board of directors positively affects the firm's financial performance following an inverted-U-shaped pattern

3. Board membership change in family firms

Shleifer and Vishny (1997) propose that when the family's control is greater than its property rights, then the potential for expropriation of minority shareholders by the company's controllers is elevated. González et al. (2015) demonstrate that boards dominated by families are more lenient with the CEO in terms of financial performance, particularly when the CEO is from the family nucleus. In this sense, family firms may adopt better corporate governance practices to substitute for the absence or inefficiency of a regulatory system and to mitigate the agency problem between majority and minority shareholders (Turrent, 2017). To mitigate agency problems, family firms have a strong incentive to increase compliance with corporate governance recommendations and promote board structures that limit the expropriation of firms' wealth (Brunello et al., 2003). It is common that family members are involved in the management and board positions, and therefore, board structure might promote or limit corporate governance compliance of family firms (Turrent, 2017). In

contrast, the greater presence of independent directors, external audit (Bebchuk and Cohen, 2005) and high reputation of the board members increase the board turnover in family businesses. In Addition, the existence of business groups and necessity to exchange information with affiliated companies, generate greater turnover (Khanna Palepu, 2000a, 2000b).

Together, this suggests that family ownership and control, represented by CEO and Chairperson within the same family nucleus, could be distinctively associated with board turnover and financial performance, which leads to the following hypothesis:

Hypothesis 2. The inverted-U shape of the relationship between board turnover and firm performance is more pronounced in family vs. non-family firms.

In contrast with non-family firms, the family firms show positive performance with the board turnover, following an inverted-U-shaped pattern

4. Method

We mapped a detailed examination on the turnover of the board of directors to discuss possible alternatives that sustain the propositions above and differentiate changes in the board of directors that may have been ignored or underestimated by scholars. Brazilian companies were sampled as the country is the leading economy in Latin America, where family businesses develop a crucial role in the region as they account for more than 85% of the companies, 60% of the GDP and 70% of the workforce (Lazzarini et al., 2020).

The database consists in 190 publicly traded companies, among large and small representation, on the Brazilian stock exchange (B3) that remained active from 2010 to 2019, without interposition of initial public offerings or companies delisted from the stock market. In terms of comparison, the Brazilian stock market is not very numerous regarding the quantity of companies listed; and there were only 353 firms listed at the end of 2012.

This period was selected due to the disclosure of the data only since 2010, when the Brazilian Securities Commission (CVM) obligatorily required the publication of information regarding the board of directors of publicly traded companies in Brazil. Furthermore, the chosen period was distinctive to Brazil since it has undergone major political, social and economic changes that appealed to more corporate governance policies for the companies that operate in the country.

Companies in the financial sector, including banks, were not considered in this study due to the particularities of the financial services that, unlike other sectors of the economy, present higher leverage as banks may exceed 90% of the equity (Adams, 2003). For statistical robustness, we performed 5% winsorization on the database to reduce the effect extreme values.

The family business representation considered only companies with family ownership above 15% of ordinary stocks, CEO and Chairperson within the same family nucleus, which represent a high degree of family interference consenting the literature (Newbert & Craig, 2017; Berrone et. al., 2012; Miller et. al, 2011; Miller & Le Breton-Miller, 2006). Board membership data were obtained from CVM (Brazilian Securities Commission) and accounting or financial indicators were extracted from the Economatica software. The board analysis procedure consisted in listing all the members of the board and managing the turnover, considering new hiring and dismissals. In other words, was considered as board membership changes a particular director in year Y-1 and not present in year Y0 or a new director that joined the board within the same period, accordingly to Gonzalez (2019). After that, it was adjusted the firm's annual turnover by the board size, the total quantity of members, in the same year. The same procedure was employed in the multivariate analyses found in the literature (Wong and Koh, 2019).

Correspondingly to the proposition of Anderson and Chun (2014) that there should be an optimal effect of board turnover on financial performance should not be linear, but resultant of a quadratic function, also was considered the quadratic form for the variables Board Membership Change. To discern the moderation effect of the Family Businesses in the econometric models, it was inserted a cross-variable (Board Membership Change and Family Business) in each regression. The financial performance construct used in this research was carefully

developed using internal and external validity criteria, in addition to convergent and nomological validity, according to the following literature.

The methodology and response variables for financial performance used in this study are accordingly to Gonzalez (2019), Wong (2019), Turrent (2017), Garcia-Castro & Aguilera (2014) and Arosa (2010). The methodology applied was fixed effects panel regression, considering the firm's annual board turnover and lagged (Y+1) financial indicators to address the problem of double causality in the turnover-performance relationship.

5. Variables

The response variables in the regressions were *ROE, ROA, Tobin's Q*.
The explanatory variables used in the regressions were Board Membership Change (Total number of hirings and dismissals of board members adjusted by the board size on annual basis)
Squared Board Membership Change variable (Quadratic function of the total number of hirings and dismissals of board members adjusted by the board size on annual basis),
Family Firms (Companies with controlling ownership above 15%, chairperson and CEO within the same family),
Cross-variable Board Membership Change X Family Business, Cross-variable Squared Board Membership Change X Family Business.

The control variables were Board Size (Total number of board members on annual basis), Total assets in natural logarithm, Net Revenue Growth, Net Debt to Total Assets Ratio and Ebit to Total Assets Ratio. The econometric regressions performed are described below and both softwares, R and Eviews 11, were used to run the econometric models and validate the accuracy of the results.

6. Main Findings

It is notable through the descriptive statistics that the family firm's cluster demonstrated lower standard deviations for all variables, except ROE that performed a superior level in average over non-family firms. Amid the essential reasons for the reduced changes on the family firms, the literature indicates the dominant recurrence of the same individual as CEO and Chairperson (Faleye, 2007; Ryan and Wiggins, 2004). Moreover, the greater presence of blockholders (Maury and Pajuste, 2005) and greater age of the members reduce the board turnover, mainly interrelated to the preservation of expertise and respect among the members (González et al., 2015). Therefore, family firms have more CEO/COB duality than in non-family firms (0.34 vs. 0.17), in the Latin America context (Turrent, 2017). The lower board membership change in family firms should be associated with the smaller size of the board, empirically evidenced in the sample. For non-family firms, the larger board of directors is justified by the additional knowledge, to increase certain firm's expertise not directly related to its core, usually in conditions less likely to be dominated by the actual management (Hussainey & Al-Najjar, 2012). The afore mentioned phenomenon seems to be different in family firms, since this cohort is comparatively more profitable than non-family firms as mentioned in the literature review, therefore the resource use for the board of directors should be more restrained.

Table 1: Descriptive statistics of the complete sample, non-family and family firms' clusters

	Complete Sample (N = 190)					Non-Family Firms (N = 142)					Family Firms (N = 48)				
	Average	Median	SD	Min	Max	Average	Median	SD	Min	Max	Average	Median	SD	Min	Max
Dependent Variables															
Revenue Growth	0,2646	0,3125	0,6707	-2,7084	13,3265	0,2655	0,3125	0,7841	-2,7084	13,3265	0,2629	0,3133	0,3779	-0,6797	5,3933
Total Assets (Ln)	14,1999	14,7868	3,7934	0,0000	20,6464	14,1166	14,7897	4,1780	0,0000	20,6464	14,3554	14,7702	2,9448	0,0000	18,6545
Debts/Assets Ratio	1,8205	0,2170	8,6563	0,0000	111,7225	2,1376	0,2147	9,8778	0,0000	111,7225	1,2289	0,2290	5,6868	0,0000	45,3004
Ebit/Assets Ratio	0,0804	0,0679	0,1544	-0,6643	2,2119	0,0872	0,0679	0,1864	-0,6643	2,2119	0,0676	0,0663	0,0576	-0,2002	0,3118
Response variables															
ROE	0,1698	0,0847	0,9858	-12,1932	20,8132	0,1679	0,0800	0,8184	-12,1932	6,6173	0,1735	0,0887	1,2407	-3,9490	20,8132
ROA	0,0510	0,0206	0,1539	-0,9834	2,2177	0,0594	0,0214	0,1867	- 0,9834	2,2177	0,0352	0,0184	0,0502	-0,1527	0,4134
TOBIN'S Q	0,9724	0,7065	1,2011	0,0000	24,2358	1,0226	0,7554	1,3632	-	24,2358	0,8786	0,6333	0,8104	0,0000	5,2960

Descriptive statistics of the dependent and independent variables used in the study. The variables definitions are provided in the section Database and methodology; Family Firms: Companies with controlling ownership above 15%, chairperson and CEO within the same family; Total assets in natural logarithm; Net Revenue Growth; Net Debt to Total Assets Ratio; Ebit to Total Assets Ratio; ROE (Return on Equity); ROA (Return on Assets) and Tobin's Q.

Source: Developed by the author.

Regarding board membership changes, we argue that the turnover should vary between FB and NFB depending on key features favoring or constraining the variances of the decision-making contexts, besides corporate governance mechanisms and idiosyncrasies of each cluster or company. Among the 48 family firms on the

sample, the average annual membership change (2.32 members) was lower than non-family firms (3.47 members) and the board size was reduced (9.66 members vs. 11,19 members) as expected, since the presence of family members in the board is frequently relevant and constant.

The univariate analysis demonstrates that board size and board membership changes present a positive correlation for the complete sample, but negative correlation regarding only family firms. Concerning the response variables ROE and ROA, the correlation matrix shows that board membership changes are positive correlated, whilst the quadratic function of the variables Board Membership Changes and Board Change X Family Firm revealed negative correlated to Tobin's Q. Following, the correlation matrix of all variables analyzed is presented.

Table 2: Correlation Matrix

Correlation Matrix	Board Membership Change	(Board Membership Change)²	Board Change X Family Firm	(Board Change X Family Firm)²	Board Size	Family Firm	Revenue Growth	Total Assets (Ln)	Debts/ Assets Ratio	Ebit/Assets Ratio	ROE	ROA	Tobins'Q
Board Membership Change	1												
(Board Membership Change)²	0.8169	1											
Board Change X Family Firm	0.4325	0.2689	1										
(Board Change X Family Firm)²	0.4067	0.3197	0.8914	1									
Board Size	0.1938	0.1214	-0.0165	-0.0243	1								
Family Firm	-0.1017	-0.0544	0.3035	0.1879	-0.2086	1							
Revenue Growth	-0.0455	-0.0275	-0.0273	-0.0387	0.0295	-0.0018	1						
Total Assets (Ln)	0.1296	0.0874	0.1061	0.0556	0.2882	0.0300	0.0663	1					
Debts/Assets Ratio	-0.0168	-0.0178	-0.0403	-0.0253	-0.1306	-0.0500	-0.0690	0.0376	1				
Ebit/Assets Ratio	-0.0007	-0.0114	-0.0120	-0.0275	0.0623	-0.06072	0.0127	0.1075	-0.0768	1			
ROE	0.1759	0.1896	0.2742	0.4841	0.0478	0.0027	-0.1107	0.0232	-0.0315	0.1878	1		
ROA	0.0025	0.0116	0.0108	0.0427	0.0512	-0.0748	0.0333	0.0139	-0.1088	0.8314	0.2860	1	
Tobins'Q	0.026	-0.0025	0.0069	-0.0135	0.0344	-0.0572	-0.0044	0.1811	0.1737	0.1390	0.01559	0.0360	1

Source: Developed by the author.

The multivariate analyses (Model 1, 2 and 3) or which table? appointed both Board Membership Change variable and its quadratic function were not statistically significant in the three equations tested (b= xxx, p= xxx), therefore the results do not support H1 that the relationship between board membership changes and financial performance presents an approximation of a quadratic function.

Contrarily, both cross-variables Board Membership Change and Family Firm and its quadratic function demonstrated to be statistically significant for ROE (b= xxxxx, p<0.001) (0.0000 and 0.0000, respectively) and ROA (b= xxxxx, p<0.001) (0.0026 and 0.0000, respectively). That appoints to the association between board turnover and the short-term internal financial performance indicators to this cohort. The results reveal that H2 is not rejected, as the relationship of the moderating impact of family-controlled firms over the effect of board membership changes and the financial performance is statistically significant. The opposite coefficients signals of the variables Board Membership Change and Family Firm for ROE and ROA (-5.1901 and -0.1375, respectively) and its quadratic form (6.1666 and 0.1649, respectively), demonstrates positive impact of board membership changes for family firms, above a certain interval. The CEO duality, that is more predominantly in family firms, can be effective during financial crisis or when the organization is at its early stage as it ought to promote fast decision making and united decisions (Palanissamy, 2015). Another curious perspective is that the cross-variable (Board Turnover and Family Firm) reiterated the stewardship theory, that a centralized authority leadership could lead to management's domination of the board and result in poor performance (Dalton, 2006).

The Family Firm variable was statistically significant only for the ROE response variable regression model, corroborating with the literature that this specific group uses its resources more efficiently (Goel & Jones, 2016, Anderson et al 2012; Chrisman & Patel, 2012; Allouche et al, 2008) and even more when family members serve as CEO (Anderson, 2003). Amid reasons that support these arguments, the family's wealth is intricately linked to the company's well-being, hence families may have strong incentives to monitor managers and minimize the free rider problem inherent in small shareholders (Anderson, 2003). Anderson et al. (2004) suggests that the sustained presence of the family in the company also creates powerful reputation effects that provide incentives for family managers to improve the company's performance. Consequently, the active participation of the family in the management of the company can lead to a performance differential performance compared to non-family companies. Conversely, family firms may respond to institutional pressures in a more substantive manner to maintain a good reputation and project a positive family image (Liu, Valenti, & Chen, 2016). In addition, family firms have reputational concerns to attract external equity investment (Turrent, 2017). Hence, the low family power resulting from the presence of non-family owners and managers, would increase the conflict of interests due to the separation of ownership and control (Corbetta & Salvato, 2004).

The regression model for Tobin's Q do not demonstrate statistically significant relation between the variables tested, hence no inference can be obtained regarding the expected financial performance with this financial indicator that contains the firm's market capitalization on it.

Table 3: Regressions summary for ROE, ROA and Tobin's Q

Variables	ROE	ROA	Tobin's Q
BOARD MEMBERSHIP CHANGE	0,3226	0,3424	0,6389
	0,1664	-0,0175	0,1202
	0,9896	-0,9498	0,4694
(BOARD MEMBERSHIP CHANGE)²	0,7037	0,4494	0,5499
	-0,0003	0,0001	-0,0007
	-0,4804	0,7568	-0,5981
FAMILY FIRM	**0,0598***	0,4002	0,1378
	0,1180	-0,0057	-0,1417
	1,8849	-0,8417	-1,4853
BOARD CHANGE X FAMILY FIRM	**0,0000*****	**0,0026*****	0,3430
	-5,1901	-0,1375	0,6011
	-12,4819	-3,0116	0,9488
(BOARD CHANGE X FAMILY FIRM)²	**0,0000*****	**0,0000*****	0,3237
	6,1666	0,1649	-0,4755
	19,5085	4,7589	0,9874
REVENUE GROWTH	**0,0007*****	0,1390	0,8832
	-0,1332	0,0063	-0,0087
	-3,4115	1,4809	-0,1469
TOTAL ASSETS (LN)	0,8139	**0,0002*****	**0,0000*****
	0,0017	-0,0030	0,0588
	0,2354	-3,7899	4,5516
DEBT/ASSET RATIO	0,5844	**0,0399****	**0,0000*****
	-0,0016	-0,0006	0,0241
	-0,5471	-2,0583	5,1668
EBIT/ASSET RATIO	**0,0000*****	**0,0000*****	**0,0001*****
	1,3424	0,8353	1,0181
	7,8743	44,6921	3,9199
BOARD SIZE	**0,0680***	0,3929	0,7605
	0,0091	0,0004	-0,0023
	1,8274	0,8548	-0,3049
C	0,7574	**0,0163*****	0,2686
	-0,0321	0,0275	0,1757
	-0,3090	2,4077	1,1070
SAMPLE SIZE		1330	
ADJUSTED R^2	0,4066	0,7073	0,0829

Summary table of the regression results with control variables: Board Membership Change, Family Firm, Board Change*Family Firm, Total Assets (ln), Revenue Growth, Debt / Asset Ratio, Ebit / Asset Ratio, Board Size. Response variables are: Tobin's ROE, ROA, and Tobin's Q. The regressions presented are panel least squares with fixed effects. Results for P-Value are in bold when corresponding to ≤ 10% and indicating *, ** and *** to represent statistical significance at the 10%, 5% and 1% levels respectively.
The results presented are in order: P-Value, Coefficient and T-Statistics.

Source: Developed by the author.

The results demonstrated a strong connection with the literature and incremented the proposition that family firms with strong influence and control could capture beneficial effects associated with board turnover and short-term financial performance indicators. The none statistically significance of the Board Membership Change X Family Firm variable in the Tobin's Q response regression, rejected the probability of financial gains regarding the signaling to the capital market that the company is continually addressing generational issues or improving the professionalization of family firms.

7. Conclusions and new directions

The regression models demonstrated that family firms may obtain beneficial effects over non-family firms related to board membership changes on short-term financial performance indicators (ROE and ROA), by reason of the cross-variable (Board Turnover and Family Firm) be statistically significant and with positive coefficient in the quadratic form. Above a certain level of board membership variations, these gains could be related to high rate of family members exchange that preserve the essence of the company as well as bringing complementary points of view, whilst few board membership changes in non-family firms may be more attributed to the self-preservation of its members. Additionally, financial performance contribution generated by board membership changes in family firms could be related to the integration of new directors with weaker biases regarding the use of the company's assets once previous members of the board might have been favorable to acquire or

preserve underperforming assets. In this sense, it is proposed a peculiar approach on board membership turnover and financial performance that can foster the discussion concerning aspects that differentiate one group from another. The limitations of this study include data accessibility and available variables, along with the risk of endogeneity. Future studies could collect data from privately held companies to compare the results.

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