FAMILY BUSINESS, DIRECTOR COMPENSATION AND BOARD EFFICACY: THE CASE OF TAIWAN

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Abstract

This paper investigates the impact of outside directors on firm performance during legal transitions and examines how the roles of family business and director compensation influence board efficacy. By using Taiwanese listed companies as our sample, the empirical results show that outside directors who are appointed by legal mandate have less positive impacts on firm performance than outside directors appointed voluntarily. Family business weakens the positive impact of outside director on firm performance. The evidence further suggests that director compensation contributes to firm performance, particularly when outside directors are voluntarily appointed. The findings provide western managers with an understanding of how the typical Chinese family business affects board independence. We also demonstrate and incorporate the cultural and the ownership characteristics into the analysis to present a country-specific pattern that should be informative for foreign investors who are concerned about the quality of corporate governance in East Asia.

Keywords: Corporate Governance, Outside Director, Family Business, Director Compensation

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Introduction

Much attention has been directed toward corporate governance reforms on the part of both theorists and practitioners, particularly following major corporate scandals such as Enron and WorldCom in the United States. Although a number of studies have investigated why such business empires collapses, consistent explanations are lacking. Some scholars (e.g., Dewing and Russell, 2004) suggest that the scandals occurred partly because of the lack of corporate disciplines and partly because of the insufficiency of market prescriptions. Other scholars (e.g. Clement, 2006) explore the American corporate scandals from the business ethics perspective. Being aware of the leakages of institutional regulations, many countries have subsequently started to initiate or reinforce their corporate governance systems to prevent such kinds of scandals from happening again.

The initiatives behind the corporate governance reforms often stem from responses to various imperatives, such as corporate raids, capital market globalization, and intentions to enhance investor confidence (Rhee and Lee, 2008). For example, Taiwan, as an emerging country in East Asia, seeks to upgrade her weak legal systems (La Porta, Lopez-de-Silances, Shleifer and Vishny, 1997) to an extent which complies with international corporate governance standards. Therefore, the Taiwan Stock Exchange (TSE) has taken steps to improve the quality of corporate governance. One of the primary policies that the TSE has initiated is to request initial public offering (IPO) companies from 2002 onwards to introduce at least two independent outside directors (henceforth referred to as outside directors) to their boards before they are permitted to be listed.

However, it remains an open question whether outside directors appointed by legal mandate are effective in enhancing corporate values. Although there have been many studies that investigate the relationships between the presence of outside directors and firm performance, a paucity of literature detracts from investigating the efficacy of outside directors based on the condition of legal mandate. Many scholars suggest that there is a connection between directors and firm performance (e.g., Luan and Tang, 2007; Kumar and Zattoni, 2013; Peng 2004; Peng, Buck and Fliatotchev, 2003). Peng (2004) finds that outside directors do have a positive effect on firm performance measured in terms of sales growth, while they have insignificant impact as measured by the return on equity. Similarly, Luan and Tang (2007) further confirm the positive impact of independent directors on firm performance. But, to date, little attention has been directed to enhancing our understanding of the differences of efficacy of outside directors who are appointed by voluntariness of companies themselves or by legal mandate.

Given that, this study aims to investigate whether Taiwan's corporate governance reforms on board independence have a positive influence on firm performance arising from legal requirements to appoint outside directors. Since family business is a dominant form of business organization and has highly concentrated ownership structure in Taiwan (Luo and Chung, 2005), understanding the influence of Chinese family business on the board of directors is paramount. Thus, this study will also explore how family business influences board efficacy and the effects of director compensation on firm performance in light of different motivations firms appoint board of directors.

The empirical results suggest that outside directors appointed voluntarily will have a positive effect on firm performance, while outside directors introduced to the boards by legal mandate will have relatively weak impact on firm performance. We also find that family business characteristics hindering the impact of outside director on firm performance. Although many studies suggest that director compensation is positively related to firm performance (Brick, Palmon and Wald, 2006), the results extend our knowledge by depicting that director compensation has relatively weak effects in circumstances where outside directors are appointed by legal mandate.

Corporate governance development in Taiwan

The consensus for improving corporate governance is rapidly prevalent in Taiwan through both ways from corporate self-discipline and from official policy enforcement. For the past two decades, Taiwan has ever been criticized for her lack of comprehensive legal system to increase financial transparency and to reduce the analyst bias (La Porta, Lopez-de-Silanes and Shleifer, 1999). Pubic opinions thus urge the government to initiate legal reforms to protect investors' wealth. Furthermore, ownership structure is also an important factor that worsens the corporate governance quality. Yeh et al. (2001) identified 70% of Taiwanese listed companies are controlled by families or their owners. This feature has led to the prevalent phenomenon that the owner family is usually also serving as the CEO, and the selection of directors is probably decided by their personal relationships with the owners rather than in accordance with their expertise, which cause severe business ethics issues.

Business groups, a dominant form of business organization in Taiwan business system, are paramount to Taiwan's economic growth. They contribute about 54 percents to Taiwan's GDP (Chu, 2004). Thus, such form of organization cannot be ignored when addressing the nature of corporate governance system in Taiwan. Member firms in business groups are commonly linked through equity shareholdings (La Porta et al., 1999), and the group at the center often exercises strategic control over the affiliates through interlocking directorates of family members. These cross-directorate relationships may provide a channel through which the group can expropriate minority shareholders' interests. For example, the group at the center may benefit from arbitrage among affiliates through "tunneling," which has been described as transferring resources from one affiliate in which the controlling family has few cash flow rights to other affiliates in which it has considerable cash flow rights (Bertrand, Mehta, and Mullainatha, 2002). Such agency issues have been existed for many years in Taiwan and become the driving force behind improving the effectiveness of corporate boards.

Given the escalating emphasis on the effectiveness of corporate boards, many studies find that the boards of directors may become dysfunctional when exercising their duties. For example, Jensen (1993) claims that boards of directors are limited to fulfill their responsibilities effectively because the board culture may discourage team conflicts that inhibit directors from speaking up in the board meetings. This argument may be applicable to Taiwanese family business system in which group harmony is emphasized because of the coherent kinships or friendships. Such ineffectiveness of board directors has caused many financial and managerial scandals in Taiwan (Lee and Yeh, 2004), and the exploitation will not be lessened unless the corporate governance mechanism can be upgraded.

In order to tackle the increasing agency problems and respond to the escalating competitions following Taiwan's entrance to the World Trade Organization, it is even more urgent for Taiwan to initiate corporate governance reforms to catch up with international corporate governance standards and face the challenges presented by the global markets. In this sense, the Securities and Futures Commission (SFC) in Taiwan has attempted to implement institutional reforms by introducing recommendations: (i) to protect shareholders' rights and interests; (ii) to strengthen the powers of the board of directors; (iii) to enable supervisors to fully exercise their roles; (iv) to respect stakeholders' rights and interests; and (v) to enhance information transparency. Based on these recommendations, the TSE amended the listing rules to formally request that at least two outside directors should be appointed onto the boards when companies seek to be listed on the stock exchange from 2002 and should keep maintaining at least two outside directors on the board. Hence, Taiwan presents an appropriate research setting to understand the efficacy of corporate governance reforms during legal transitions.

Hypotheses

Voluntary vs. Mandatory Directors

According to the "Corporate Governance Best-Practice Principles for TSE/GTSM Listed Companies" issued by the TSE, any companies seeking to be listed on the stock exchange are mandated to appoint at least two outside directors onto their boards. Although these new listing rules become effective in 2002, there are companies which are listed before 2002 and not restricted by new listing rules but remain voluntarily appointing outside directors onto their boards. In the absence of legal mandate, such voluntary actions imply that these companies have the intentions to reform their board structures and thus to improve their corporate governance since they are not requested by the law to do that. Under this circumstance, outside directors appointed voluntarily can exert their duties without inappropriate interventions from the CEO or large shareholders since the primitive objectivity of their appointments is to help the firm enhance firm performance. Therefore, this study argues that companies that voluntarily appoint outside directors to their boards might have more of an intention than other firms to improve the corporate governance quality, and outside directors are able to independently review and monitor management's operations and promote firm performance (Luan and Tang, 2007).

By contrast, companies listed on the stock exchange after 2002 had to follow the new listing rules which request IPO firms to introduce at least two outside directors to the boards. Following the new listing rules, companies employ outside directors who are qualified nominally based on the criteria issued by the TSE. However, how much the outside directors are independent and how much they are able to exercise their obligations is a question. In the real world, their presence on the boards may be just for meeting the bottom-line standard of corporate governance and thereby comply with the legal requirements to make the companies successfully listed. The selection of outside directors in such instances cannot avoid the influences of *guanxi* in the Chinese cultural contexts (Fan, 2002). Outside directors, thus, are nominally qualified to be independent on the boards but they are indeed having personal connections with their nominators directly or indirectly. Whether they have the expertise for monitoring or have ties for organizational boundary spanning (Luan and Tang, 2007; Peng, 2004) are not the points in the priority that the companies concern about. For this reason, outside directors might be reluctant to take a stance that goes contrary to management and even fail to bridge the companies to accessing the external resources. To sum up, this study argues that outside directors who are appointed by legal mandate will have a less positive impact on firm performance than those who are appointed voluntarily.

Hypothesis 1: The proportion of outside directors appointed on the boards by legal mandate has a less impact on firm performance than that of outside directors appointed voluntarily.

Family Business

Family business is a dominant form of business organizations in Taiwan (Chen, Yen, Fu and Chang, 2007; Luo and Chung, 2005, Wu, 2006; Yeh et al., 2001). These studies point out that the firms in Taiwan are usually controlled directly or indirectly by their founding families. Traditionally, the founder, who is also the owner, builds the enterprise and expands the scope of the business in his own way. While the power of the family was transited to the subsequent generations or the outsiders, the founding families still can hold the majority of shares and large proportion of board seats (Yeh, 2005; Yeh et al., 2001) to direct the companies' operations.

The distinctive features of Chinese family business can be broadly categorized by ownership structure and information asymmetry. Filatotchev et al. (2005) suggest that family ownership structure generates effects pro and con on firm operations. Generally, family business can reduce agency costs between owners and managers and thus enhance firm performance. However, family business also is criticized for their exploitation of the wealth of minority shareholders (La Porta et al, 1999) and for their weak financial transparency (Gul and Leung, 2004). To maximize family wealth, family businesses may keep all information in family (Luo and Chung, 2005). Outsiders are difficult to know the whole real operations even on the seat of the board. Considering the power of family business, we suggest that the positive impact of outside directors on firm performance will be mitigated.

With these regards, we argue that outside directors appointed will improve the quality of corporate governance and further to enhance firm performance. Unlike the separation of ownership and management in widely-held companies, family business is a distinct form of business organization, and in Chinese society, business is part of the family's private assets or property is widely accepted (Hamilton, 1998) so that managerial positions are occupied by family members who have close kinships with the controlling family. Compared with widely-held companies, family involvements are able to reduce agency costs (Zahra, 2003). This is to say, the conflict between the manager and the family members is not severe because of the alignments of interests between owners and managers (Filatotchev et al., 2005). That explains why outside directors in the family business are less important than the widely-held companies since the primary purpose of outside directors is to monitor whether the business decisions of the manager are aligned with the interest of the shareholders. However, as the manager of family business is the same as the owner who has common interest, thus, even if the outside director is employed by the family, the influence to the business efficiency is not as prominent as that of the outside directors of the widely-held companies.

Concerning the second future of Chinese family business, many scholars suggest that all information keeping in the family is more salient in the Chinese family business (Luo and Chung, 2005; Pye, 1985). The founding family builds up the business and forms the inner circle to control and manage the business (Hamilton, 1998). In an earlier work, Pye (1985: 70) states that "The Chinese were taught to recognize a vivid distinction between family members, who could be relied upon, and non-family people, who are not to be trusted except in qualified ways." In the previous studies, Luo and Chung (2005) argue that social relationships in Chinese society are structured in concentric circles, with family members in the innermost circle and strangers in the outer circle. The remarks indicate family connections are the closest relationships in the organization that outsiders are not easy to participate in the decision formation of such core circle. Similarly in Korea, Chang (2003) argues that family may use insider information to increase their shares in successful business group affiliates through exploiting wealth of outsiders. Thus, family erects a wall to separate outsiders from their cores. Non-family member or outsiders lack affinity and blood relationships that make them hardly obtain insider information and exercise their duties successfully. Outside directors, as they are outsiders, may not able to obtain critical information from family business to make effective suggestions or monitoring on the boards. Hence, the following hypothesis is formulated:

Hypothesis 2: The proportion of outside directors appointed by a family business has a less impact on firm performance than that of outside directors appointed by a non-family business.

Director Compensation

Director compensation reflects the value added to companies by directors' decisions. Unattractive compensation may not be able to motivate directors to maximize shareholder value (Felo, 2001; McClain, 2012). Drawing on optimal contracting theory (e.g., Gaver and Gaver, 1995), compensation policy is set up in accordance with the values which the directors can create. In a recent study, Young and Tsai (2008) argue that compensation can motivate nonfamily CEO to utilize their social capital in executing corporate operations. In a similar vein, Linn and Park (2005) suggest that outside directors must be rewarded accordingly if they view their efforts costly, otherwise they will not take the job. The compensation also influences whether the directors can commit to exercise their duties. Although compensation packages are designed differently among companies, it is a general consensus that providing appropriate incentives can encourage directors to act in the interests of shareholders (Linn and Park, 2005).

Based on the importance of the compensation incentives discussed above, the next question is whether the impact of director compensation on firm performance is influenced by the two forms of outside directors. Previous research argues that board compensation is positively associated with firm performance (e.g., Crespí-Cladera and Gispert, 2003), we also suggest that compensation has greater incentive effects when outside directors are appointed voluntarily. This can be interpreted that companies voluntarily appointing outside directors onto their boards explicitly show their intentions to enhance firm performance by improving their corporate governance mechanism. Since firms intend to enhance their performance by appointing outside directors, the voluntary outside directors can exercise their duties independently with relatively low level of intervention. Building on the above work, we can conclude that the better performance the firm achieves, the higher level of compensation the directors receive. The level of compensation induces them to maximize their efforts by supervising and providing suggestions to enhance firm performance.

The mandatory outside directors are appointed by legal requirements. In most instances, given that this type of outside director is compulsorily nominated, companies tend to introduce those who nominally meet the qualifications that are required of an outside director, but they may not wholeheartedly expect the outside directors to vigilantly monitor the firm while on the board. Hence, board efficacy will decline because, for conforming to legal requirements, the CEO tends to nominate new directors who are indebted for their appointments, which undermines board independence (Ryan and Wiggins III, 2004).

Additionally, Brick, Palmon and Wald (2006) state that well-compensated directors have a lower inclination to "rock the boat." Thus, mandatory outside directors will be conservative in providing constructive criticism to the board. In this sense, although they are referred to as "independent" outside directors, their nominations might be initiated by legal requirements to help IPO firms be successfully listed. The compensation incentive effects should be relatively weak for outside directors appointed by legal mandate. The following hypothesis is formulated:

Hypothesis 3: The association between outside director compensation and firm performance will be less pronounced as outside directors are appointed by legal mandate.

Methods

Sample and Data

The data used to test the hypotheses is drawn from 2002 and 2003 annual reports of Taiwanese listed companies and the database maintained by the Taiwan Economic Journal (TEJ). The TEJ is the most prestigious database in academic research in Taiwan and is widely subscribed to by many international research agencies including Datastream and Reuters. The data we used spans only two years, due to the lack of data on individual director compensation from 2004. The new listing rule, requesting IPO firms appointing at least two outside directors on the board, became effective in 2002.

There are two types of outside directors in this study. One is outside directors who are voluntarily appointed without any legal mandate. The other type is outside directors whose companies were initially listed in 2002 or later since they were appointed after the new legal requirements took effect. In addition to identifying the types of the outside directors, the annual reports also provide information regarding the directors' compensation. This paper has drawn on annual reports to obtain data including details of outside directors and director compensation. The data for the remaining variables are obtained from the TEJ database. After cross-checking the information regarding the selected variables from both the annual reports and the TEJ database, a total of 1,686 observations are included in the sample to test our hypotheses.

Our sample includes 1,686 companies. There are a total of 810 companies in 2002, including 666 initially listed before 2002 and 134 initially listed in 2002. Similarly, 876 companies are included in 2003, consisting of 664 companies initially listed before 2002, 121 companies initially listed in 2002 and 101 companies initially listed in 2003. The sample set shows that 21%of the sample companies are listed after 2002, which are requested by legal mandate to appoint at least two outside directors to the boards.

Model Specification

We use the following multiple regression to test our hypotheses. To be consistent with our hypotheses, we predict that the coefficient estimate of *OUTDIR*LM* is negative (H1), and the coefficient estimates of *OUTDIR*FAMILY* and *COMPEN*LM* are negative (H2 and H3). Definition of each variable is addressed in next section.

$$Tobin's\ Q_{it} = \beta_0 + \beta_1\ OUTDIR_{it} + \beta_2\ LM_{it} + \beta_3 OUTDIR_{it}*LM_{it} + \beta_4\ FAMILY_{it} + \beta_5\ OUTDIR_{it}*FAMILY_{it} + \beta_6\ COMPEN_{it} + \beta_7\ COMPEN_{it}*LM_{it} + \beta_8\ DEVATION_{it} + \beta_9\ BOARDSIZE_{it} + \beta_{10}\ CEODUA_{it} + \beta_{11}\ SIZE_{it} + \beta_{12}\ LEV_{it} + \beta_{13}\ AGE_{it} + Industry\ control_i + Year\ control_t + \varepsilon_{it}$$

Measures

The dependent variable, *Tobin's Q*, is used to measure firm performance (e.g., Yeh, 2005), measured by the replacement cost of the assets divided by the book value of the assets. Due to the lack of replacement cost data, we gauge it as the market value of the assets divided by the book value of the assets (for a similar approach, see Lehn et al., 1990 and Yeh, 2005). Outside director *(OUTDIR)* is measured by the number of outside directors divided by the total number of board members. The number of outside directors is calculated based on the total number of board members according to the qualifications that TSE required. Dummy variable (*LM*) is set, coded as 1, if firms are initially listed in and after 2002 since these firms are requested by legal requirements to appoint outside directors on the boards. Family (FAMILY) is coded as 1 when the firm's CEO is the founding family members and when family members hold over half the total board seats (e.g., Tsai, Hung, Kuo and Kuo, 2006), otherwise 0. Director compensation often consists of a package of bonus and cash (Cordeiro, Veliyath and Eramus, 2000). In Taiwan, the annual reports of listed companies are used to piece together all kinds of compensation into a total cash amount disclosed in the financial reports. Consequently, outside director compensation *(COMPEN)* is measured as the average amount of total bonus and salaries received by each outside director divided by the firm's total assets, in which the stock-based compensation is counted by multiplying the number of bonus shares by the stock price on the day when the annual shareholder meeting was held.

To control for some potential confounding effects, several control variables are included. Prior studies suggest that agency problems influences firm performance. La Porta et al. (1999), Claessens, Djankov and Lang (2002) and Yeh et al. (2001) point out the existence of agency problems arising from the divergence between the controlling and the minority owners. Yeh et al. (2001) suggest that as the divergence between the controlling and the minority owners escalates, firm performance will become worse. In this sense, we control for the divergence between the controlling and the minority owners and define *DEVATION* as the controlling rights minus the cash flow rights. Furthermore, board size and CEO duality also affect firm performance (e.g., Yermack, 1996). We control for board size(*BOARDSIZE*), defined as the number of directors who have been appointed on the board, and CEO duality, measured as a dummy variable (*CEODU*) , coded as 1 when CEO is also the chairman, otherwise 0. Firm size (*SIZE*) is measured as the logarithm of firm sales. *Firm leverage* (*LEV*) is measured as debt divided by sales. Firm age (*AGE*) is measured as the number of years the firm had been in operation. Firm performance will be influenced by a firm's initial public offerings. After a firm goes public, its performance will decline (Kim, Kitsabunnarat and Nofsinger, 2004). Finally, industry membership and year are also controlled as dummy variables. *Year control* includes a set of dummy variables representing the fiscal year; *Industry control* includes a set of dummy variables representing the industry.

Results

Table 1 presents the descriptive statistics, including the means, standard deviations and Pearson correlation matrices of all the variables used. The average of the number of outside directors divided by total number of board members is 0.06. The mean of Tobin's Q is 1.29. The mean of LM equals 0.21, indicating that twenty one percent of the firms are requested by law to appoint outside directors on the boards. Fifty eight percent of the sample firms is family businesses. In order to examine the multicollinearity between the variables, the procedure proposed by Neter et al. (1985) was used to calculate the VIF (variance inflation factor) values and the results suggest that there was no problem due to multicollinearity with all the VIF values being less than 10.

Table 1. Descriptive Statistics and Pearson Correlation Coefficients

	Variable	Mean	S.D.	1	2	3	4	5	6	7	8	9	10
1	Tobin's Q	1.29	0.63										
2	OUTDIR	0.06	0.12	0.30***									
3	LM	0.21	0.41	0.37***	0.50***								
4	FAMILY	0.58	0.49	-0.22***	-0.26***	-0.25***							
5	COMPEN	0.00	0.00	0.03*	0.07***	0.05**	-0.02						
6	DEVATION	0.04	0.08	0.06**	-0.01	0.08***	0.18***	-0.02					
7	BOARDSIZE	6.82	2.58	-0.04	-0.04	-0.03**	-0.08**	0.02	0.16**				
8	CEODUA	0.37	0.48	0.04*	0.11***	0.05**	-0.04**	0.01	-0.17***	-0.19***			
9	SIZE	21.61	1.37	0.12***	-0.06***	-0.11***	0.07***	0.00	0.13***	0.28***	-0.13***		
10	LEV	0.42	0.17	-0.24***	-0.05**	-0.06**	-0.05**	0.01	-0.12***	-0.00	-0.01	0.14***	
11	AGE	23.83	11.78	-0.32***	-0.22***	-0.37***	0.31***	0.02	-0.08***	0.23***	-0.14***	0.15***	0.07**

*Significance level: *** indicates P<0.01; ** indicates P<0.05; * indicates P< 0.1*

Table 2 shows the results of analyses to test our hypotheses. The results of Model 1 show the coefficient on OUTDIR (outside director) to be positive (0.745) and statistically significant (*P* value < 0.01) while the coefficient on OUTDIR × LM (outside director × legal mandate) is negative(-0.615) and significant (*P* value < 0.01). The empirical evidence suggests that outside directors have positive effects on firm performance but if outside directors are appointed by legal mandate, the performance effects will diminish. Hypothesis 1 is supported.

In Model 2, we consider the family business effects. The coefficient on OUTDIR × FAMILY (outside director × family business) is negative (-0.548) and significant (*P* value < 0.05), indicating that the impact of outside directors on firm performance will be mitigated when outside directors are appointed by family business. Hypothesis 2 is supported. In order to test Hypothesis 3, we conduct additional analysis by entering compensation data. In Model 3, the results show that Hypothesis 3 is supported. The coefficient on COMPEN (director compensation) is positive (7.687) and insignificant while the coefficient on COMPEN × LM (director compensation × legal mandate) is negative (-2.439) and significant (*P* value < 0.05). The results indicate that director compensation has less incentive impacts on firm performance when outside directors are appointed by legal mandate.

As for the control variables, LM, and SIZE show positive relationships with firm performance, indicating that legal mandate, large firm size and initial public offerings have positive impacts on firm performance. In contrast, LEV and AGE show a negative relationship with firm performance, indicating that high debt ratio and being older firms have negative impacts on firm performance.

Table 2. Results of Multiple Regression Analyses

Variable	Tobin's Q		
	Model 1	**Model 2**	**Model 3**
Constant	-0.219 (0.259)	-0.265 (0.169)	-0.265 (0.170)
OUTDIR	0.745 (0.000)***	1.099 (0.000)***	1.081 (0.000)***
LM	0.381 (0.000)***	0.364 (0.000)***	0.362 (0.000)***
OUTDIR × LM	-0.615 (0.006)***	-0.562 (0.012)**	-0.556 (0.014)**
FAMILY		0.130 (0.000)***	0.131 (0.000)***
OUTDIR × FAMILY		-0.548 (0.024)**	-0.540 (0.026)**
COMPEN			7.687 (0.516)
COMPEN × LM			-2.439 (0.049)**
DEVATION	-0.189 (0.176)	-0.326 (0.022)**	-0.325 (0.022)**
BOARDSIZE	-0.007 (0.136)	-0.004 (0.426)	-0.004 (0.417)
CEODUA	-0.014 (0.551)	-0.014 (0.570)	-0.014 (0.562)
SIZE	0.093 (0.000)***	0.091 (0.000)***	0.091 (0.000)***
LEV	-0.773 (0.000)***	-0.742 (0.000)***	-0.741 (0.000)***
AGE	-0.011 (0.000)***	-0.011 (0.000)***	-0.011 (0.000)***
Industry control	Not reported	Not reported	Not reported
Year control	Not reported	Not reported	Not reported
N	1686	1686	1686
F	34.236	33.015	31.046
Adjusted R^2	30.2%	32.6%	35.1%

Tobin's Q	the market value of equity plus the book value of the debt divided by the book value of the assets
OUTDIR	the number of outside directors divided by the total number of board members
LM	1 if the firms are initially listed in and after 2002, otherwise 0.
FAMILY	1if the firm's CEO is the founding family members and when family members hold over half the total board seats
COMPEN	average amount of total bonus and salaries received by each outside director divided by the firm's total assets
DEVATION	the controlling rights minus the cash flow rights
BOARDSIZE	the number of directors on the board
CEODUA	1if CEO is also the chairman, otherwise 0.
SIZE	logarithm of total sales
LEV	debt divided by asset.
AGE	the number of years the firm has been in operation

1. The number in parentheses is p value. Significance level: *** indicates P<0.01; ** indicates P<0.05; * indicates P< 0.1.
2. All the VIF values are less 10 and the results suggest no problem of multicollinearity。

To further investigate the robustness of our empirical results, we conduct sensitivity analyses to consider the IPOs effects (initial public offering) on firm performance. We set a dummy variable *IPOs* equal to one if the firm is an IPO firm in a given year, otherwise 0. Untabulated results show that the results are similar to those reported in our main analyses, reported in Table 2. Thus, the results are not attributable to the IPOs effects. The sensitivity test is also conducted with alternative time specification for director compensation data can only be obtained for two years. Without considering the director compensation data, we extend the sample time window from two years (2002 to 2003) to five years (2002 to 2006). Hence, a new set of 5,608 observations is developed and the hypothesis 1 and 2 are re-tested. The results, shown in Table 3, are similar to those reported in our main analyses, reported in Table 2.

Discussions

This paper aims to answer the research questions: (1) do outside directors appointed by voluntariness or by legal mandate generate different impacts on firm performance; (2) how do family businesses moderate the relationships between outside directors and firm performance; and (3) are the impacts of director compensation on firm performance influenced by the different motivations of firms. In general, the empirical results support our hypotheses. Prior studies have suggested that outside directors on the board would have significant effects on the firm performance (e.g., Luan and Tang, 2007; Shleifer and Vishny, 1997). This study further extends the current research progress by simultaneously considering the impacts of family business and director compensation during legal transitions. The results suggest that outside directors contribute unequally to firm performance when we classified outside directors into two types in accordance with their appointments by corporate voluntariness or by legal mandate.

The findings clearly suggest that outside directors voluntarily appointed by companies have greater positive contributions to firm performance, while those appointed for the sake of complying with legal requirements have a relatively slighter effect on firm performance. The findings indicate that even though the government has done a lot to promote corporate governance, corporate governance is still a very new concept and is in a preliminary development stage in many companies. Indeed, to many senior managers, the launch of corporate governance means increased restriction and monitoring. Therefore, if there are any mandatory regulations on corporate governance, companies may comply to meet the legal requirements, but outside directors, in this condition, will probably be symbolic figures rather than taking an actual monitoring role. In other words, a company appointing outside directors by legal mandate indicates that the appointments are not totally by corporate voluntariness so that the efficacy of outside directors may be limited or even detrimental to firm performance.

The findings also suggest that family businesses negatively moderate the relationship between outside director and firm performance. Family businesses are the dominant business system in Taiwan, and ownership is highly concentrated in the founding family (Luo and Chung, 2005; La Porta et al., 1999). Such concentrated ownership enables the founding family to occupy the majority of board seats. The core leader of the founding family usually assigns the family members to the key managerial positions. These family-related managers have blood relationship with the founding family (Luo and Chung, 2005). Even though outside directors are recruited to the board of a family business, the decisions of the family business are made mostly by family members, which outside directors find it difficult to monitor and become involved with, because they are the outsiders and not included in the inner circle of the family. Hence, the findings may be interpreted that outside directors in a family business are appointed largely for social legitimacy and to comply with the institutional needs (DiMaggio and Powell, 1983). Family businesses appointing outside directors can enhance their corporate image, showing the public and the investors a signal that they begin to dilute their familism by introducing outside directors on the boards (Rhee and Lee, 2008).

The findings show that the impacts of directors' compensation on firm performance are moderated by the different types of outside directors. Outside directors are rewarded for their efforts in terms of serving the board. However, the empirical evidence suggests that the incentive effects of compensation are more significant for voluntary outside directors. Companies which voluntarily appoint outside directors indicate the intention to improve the quality of corporate governance and probably want the best directors serving on their boards. Inadequate compensation is unlikely to attract and retain outstanding directors to fulfill the objectives of such companies. Young and Tsai (2008) suggest that compensation can induce nonfamily CEOs to utilize their social capital while family CEOs' social capital is not incentive-relevant because of their alignments of owner-managers ownership. Our results suggest that director compensation can encourage voluntary outside directors to promote corporate values, indicating higher compensation can attract better directors and also motivate the directors to improve firm performance.

Mandatory outside directors are appointed by legal mandate. The results suggest that the incentive effects of compensation are not as pronounced as with voluntary outside directors. Since the main purpose of appointing outside directors is to meet legal requirements, the incentive effects are thus eroded. Similar to the findings of Brick, Palmon and Wald (2006), excess compensation is symptomatic of cronyism, where directors fail to protect the wealth of shareholders. Our results imply that excess compensation weakens directors' monitoring, which in turn undermines firm performance. This may be interpreted that outside directors are usually nominated by the CEO or the board chair, and they are sensitively aware of the fact that they owe their positions to the CEO or the board chair. Thus, director compensation loses its function of serving as an inducement to encourage mandatory outside directors to improve firm performance.

Table 3. Results of Sensitivity Analyses

Variable	**Tobin's Q**	
	Model 1	**Model 2**
Constant	0.208 (0.140)	0.133 (0.349)
OUTDIR	0.161 (0.068)*	0.203 (0.097)*
LM	0.249 (0.000)***	0.239 (0.000)***
OUTDIR × LM	-0.535 (0.000)***	-0.554 (0.000)***
FAMILY		0.105 (0.000)***
OUTDIR × FAMILY		-0.132 (0.039)**
DEVATION	-0.232 (0.032)**	
BOARDSIZE	-0.012 (0.001)***	
CEODUA	-0.035 (0.060)*	-0.035 (0.055)*
SIZE	0.077 (0.000)***	0.078 (0.000)***
LEV	-0.871 (0.000)***	-0.850 (0.000)***
AGE	-0.008 (0.000)***	-0.009 (0.000)***
Industry control	Not reported	Not reported
Year control	Not reported	Not reported
N	5602	5602
F	56.085	53.552
Adjusted R^2	22.3%	24.1%

Tobin's Q	the market value of equity plus the book value of the debt divided by the book value of the assets
OUTDIR	the number of outside directors divided by the total number of board members
LM	1 if the firms are initially listed in and after 2002, otherwise 0.
FAMILY	1if the firm's CEO is the founding family members and when family members hold over half the total board seats
DEVATION	the controlling rights minus the cash flow rights
BOARDSIZE	the number of directors on the board
CEODUA	1 if CEO is also the chairman, otherwise 0.
SIZE	logarithm of total sales
LEV	debt divided by asset.
AGE	the number of years the firm has been in operation

1. The number in parentheses is p value. Significance level: *** indicates P<0.01; ** indicates P<0.05; * indicates P< 0.1.
2. All the VIF values are less 10 and the results suggest no problem of multicollinearity。

Implications for Theory and Practice

Several implications both for theory and practice can be drawn from this study. Prior research on the efficacy of outside directors does not distinguish the motivations by which outside directors are appointed (e.g. Luan and Tang, 2007). This study goes beyond the existing literature by extending the study of the efficacy of board independence to the extent which considers the appointments of outside directors to the boards by corporate voluntariness or by legal mandate. This is an important finding that supplements the conventional arguments which based on agency theory to interpret the failure of outside directors on the board. The results indicate that companies appointing outside directors may not really intend to improve the quality of corporate governance but just to comply with the pressure of external institutional forces. This is an implicit ethical phenomenon regarding how firms respond to legal requirements on corporate governance and our findings can offer a theoretical perspective to explain why outside directors fail to be effective by pointing out the firms' unethical pretence to have outside directors only for institutional legitimacy. This study also made contributions to family research by shedding light on the impact of family control on the efficacy of outside directors during legal transitions in corporate governance reforms. The findings indicate that the controlling family presents a defensive attitude towards outsiders. Following the logic of Luo and Chung (2005), the controlling family holds inner information and tends to "keep it all in the family." In this sense, family control makes outside directors less contributable to firm performance.

For practical implications, the findings of this study show that outside directors appointed by legal mandate cannot function well as they are expected to. On reflection, corporate governance reforms on board independence should be further developed. Policy-makers may not neglect the potential problems that "masked" outside directors may nominally conform to legal requirements but their existence may cripple the effectiveness of the corporate board and consequently erode the firm's value. Western managers can also benefit from this study by learning how the typical Chinese family business affects board independence. This paper considers the prevalent family features of Chinese businesses and finds that family factors counteract the effectiveness of outside directors. We demonstrate and incorporate the cultural and the ownership characteristics into analysis to present a country-specific pattern that should be informative for foreign investors (Rhee and Lee, 2008) who are concerned about the quality of corporate governance in East Asia.

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