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Does family involvement explain why corporate social responsibility affects earnings management?☆

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ABSTRACT

We investigate how family involvement in the ownership, management, or governance of a business affects its engagement in earnings management both directly and indirectly through its corporate social responsibility (CSR) activities. Using a sample of S&P 500 companies, we find that family firms tend to have higher CSR performance, which can help them to maintain legitimacy and preserve socio-emotional wealth. Family firms also engage in less accrual-based earnings management, although they are indistinguishable from non-family firms in terms of real earnings management. In contrast to previous research, we find that CSR performance is not significantly associated with either accrual-based or real earnings management behavior after we account for the effect of family involvement. Our findings suggest that the association between CSR performance and family involvement is the primary driver of the relation between CSR performance and earnings management documented in previous research.

1. Introduction

How family involvement in a firm's ownership, management, and governance affects business outcomes and decision making has attracted growing research attention (Dyer & Whetten, 2006; Kim, Park, & Wier, 2012; Lin & Shen, 2015; Wang, 2006). Other studies have looked into factors that affect a company's corporate social responsibility (CSR) activities. Furthermore, the 2008 financial crisis once again placed earnings management practices into the spotlight. This attention has been especially relevant in light of the Sarbanes-Oxley Act (SOX) of 2002, which restricts the ability of publicly listed companies to engage in accrual-based earnings management (AEM) (Cohen, Dey, & Lys, 2008; Zang, 2012). We aim to shed light on how family involvement affects the link between CSR and earnings management during the post-SOX era.

Kim et al. (2012) show that CSR corresponds to reduced activities of both AEM and real earnings management (REM) behavior. They attribute this association to an ethical theory of the firm, which posits that whereas ethical firms behave ethically toward both shareholders and non-equity stakeholders, unethical firms behave unethically toward both shareholders and non-equity stakeholders. Wang (2006) shows that family ownership reduces earnings management. Furthermore, Dyer and Whetten (2006) provide preliminary evidence that family firms among Standard & Poor's (S&P) 500 companies have fewer CSR concerns than their non-family counterparts, although their socially responsible initiatives do not differ significantly. However, none of these studies investigates how family involvement and CSR affect earnings management together, which reveals that the motivation for why firms choose to be ethical may have important consequences. We help to fill this gap in the literature and find that family ownership is the main driver of the association between CSR and earnings management. In other words, conditional on family ownership, the previously documented relation between CSR and earnings management disappears, which suggests that family firms are precisely those ethical firms identified by Kim et al. (2012).

The main contribution of this study is its investigation of the effect of family involvement on a firm's earnings management behavior both directly and through CSR performance. It is important to consider the self-selection issues between CSR performance and family involvement when investigating how they affect earnings management. In addition

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to the self-selection concern, there are several other reasons why our study is important. First, Dyer and Whetten (2006) highlight how family involvement affects socially responsible initiatives and concerns separately. However, as the market observes the overall CSR performance of a company while considering both initiatives and concerns, the joint or net effect of both initiatives and concerns may be more important (Dhaliwal, Li, Tsang, & Yang, 2011; Ge & Liu, 2015). We consider the socially responsible initiatives and concerns together.[1] Second, since it came into effect in 2002, SOX has significantly restricted firms from engaging in AEM, but not REM (Cohen et al., 2008; Zang, 2012). Therefore, for our post-SOX sample period, it is of particular importance to investigate the effects of family involvement on AEM and REM separately. As family firm owners grant greater priority to preserving their socio-emotional wealth (SEW) (Gómez-Mejia, Haynes, Núñez-Nickel, Jacobson, & Moyano-Fuentes, 2007; Zellweger, Kellermanns, Chrisman, & Chua, 2012), they could be less willing to risk their reputation by engaging in AEM during the post-SOX period. Therefore, family involvement should have a greater effect on AEM than on REM after 2002.

The empirically consistent and robust findings of our study indicate that family involvement does improve overall CSR performance. With the self-selection concerns resolved, we find that family involvement helps to curb engagement in AEM, although it does not significantly affect REM behavior. More interestingly, we detect no significant relation between CSR performance and engagement in earnings management after properly controlling for the link between family involvement and CSR performance. These observations indicate that, in the post-SOX period, the concern for SEW does encourage family firms to be more socially responsible and less likely to engage in AEM than non-family firms, although family involvement does not significantly affect engagement in REM. In other words, we present evidence that SEW, as it relates to family participation in a firm, is one of the main factors contributing to more ethical corporate behavior.

We add to the literature on earnings management, CSR, and family business management by shedding light on agency-theory-based corporate governance and behavior-related SEW concerns. This study addresses the importance of how preserving SEW enters into corporate behavior and financial reporting related to information transparency. It also provides crucial implications for both investors and policymakers by showing the relative engagement of family and non-family firms in earnings management during the post-SOX era, and by helping them to better understand the drivers and consequences of CSR.

The remainder of this paper proceeds as follows. Section 2 develops our hypotheses theoretically and discusses their relation to the previous literature. Section 3 describes our data and methodology. Section 4 reports the empirical results, and Section 5 concludes the paper.

2. Theoretical development and hypotheses

We address how family involvement affects a firm's earnings management activities both directly and through its CSR activity. Although previous studies have investigated each of these three topics individually, no study has explored their interrelationship. In this section, we discuss the relations among these three factors in the relevant literature.

2.1. Family involvement and corporate social responsibility

Although there are many ways to define a family business, the definition proposed by Chua, Chrisman, and Sharma (1999) is widely accepted by scholars in this field. Chua et al. (1999) define family businesses using a behavioral approach that includes each aspect of family ownership, family member involvement in management and governance, and intention for family succession. In other words, family firms are expected to retain family involvement for future generations to build a family legacy (Anderson, Mansi, & Reeb, 2003; Chrisman & Patel, 2012; Weber, Lavelle, Lowry, Zellner, & Barrent, 2003). Therefore, in addition to financial wealth, families consider non-pecuniary benefits such as SEW when making business decisions.[2] SEW represents the utility derived from the non-financial consequences of ownership and involvement with a business. When making managerial decisions, family firms often demonstrate that preserving SEW is more important than pursuing financial returns (Gómez-Mejia et al., 2007; Gómez-Mejía, Curz, Berrone, & De Castro, 2011).

Since the seminal research of Bowen (1953), CSR has shown a positive association with financial performance (Orlitzky, Schmidt, & Rynes, 2003; Waddock & Graves, 1997; Wang, Chen, Yu, & Hsiao, 2015). This evidence helps to resolve concerns about the consistency between investing in CSR and maximizing shareholder benefits. As addressed by the cost-benefit analysis of Déniz and Suárez (2005), investing in CSR may increase expenses and reduce accounting returns in the short run, but can also increase the long-term market value of a firm.

The relation between family involvement and CSR has not been explored until recently (Déniz & Suárez, 2005; Dyer & Whetten, 2006). Déniz and Suárez (2005) investigate Spanish family firms to find that different orientations toward CSR (constructed by cost-benefit analysis and broadness of firm vision) lead to differences in CSR investment. Dyer and Whetten (2006) confirm this dichotomy, suggesting that family firms may be more socially responsible due to SEW concerns (Gómez-Mejia et al., 2007). On the contrary, family firms may be less socially responsible than non-family firms due to nepotism, which can lead to self-interested behavior (Rosenblatt, De Mik, Anderson, & Johnson, 1985). These studies present preliminary evidence that family firms are more likely to be socially responsible than non-family firms due to "family concern about image and reputation and a desire to protect family assets" (Dyer & Whetten, 2006, p. 785), which fits with the SEW theory of Gómez-Mejia et al. (2007). Dyer and Whetten's (2006) seminal work is both practically and conceptually important to both family business management and the CSR literature. However, instead of considering the overall socially responsible behavior, they focus on CSR initiatives and concerns separately, so they cannot summarize the relation between family involvement and CSR conclusively, especially when firms use CSR initiatives to offset their CSR concerns (Zang, 2012). Considering the priority granted to preserving SEW (Gómez-Mejia et al., 2007), we expect family firms to be more socially responsible than non-family firms. CSR contributes to multiple dimensions of SEW, such as family legacy and reputation, as well as the preservation of a household's social capital and social status (Gómez-Mejia et al., 2007; Zellweger et al., 2012). Hence, we propose the following hypothesis.

Hypothesis 1. Firms with family involvement are more socially responsible than those without family involvement.

2.2. Effects of family involvement and CSR on earnings management

Previous research has extensively addressed agency issues between owners and managers (Jensen & Meckling, 1976) and those between majority and minority shareholders (Morck, Shleifer, & Vishny, 1989). Many studies have investigated the agency issues related to earnings management (Hadani, Goranova, & Khan, 2011; Leuz, Nanda, & Wysocki, 2003; Lin & Shen, 2015). For family firms, the conflict between family owners and minority shareholders fits into the majority–minority shareholder agency framework (Wang, 2006). Due to SEW and

[1] For robustness, we also consider these aspects separately.

[2] SEW includes "fulfilling needs for belonging, affect, and intimacy; continuation of family values through the firm; perpetuation of the family dynasty; preservation of family firm social capital; discharge of family obligations based on blood ties; [and] ability to act altruistically toward family members using firm resources and social status" (Zellweger et al., 2012, p. 851).