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Family firms and earnings management in Taiwan: Influence of corporate governance

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ABSTRACT

This study examines the relationship between family firms and earnings management by considering the influence of board independence. Based on a sample of 379 listed high-technology firms over 7 years in Taiwan, we find that family firms are positively related to earnings management. Further, we find two interaction effects: (1) the proportion of independent directors interacted with family firms to reduce the earnings management, and (2) CEO duality interacted with family firms to increase the earnings management. Our findings suggest that board independence is important for an emerging market to mitigate the earnings management behavior carried out by family firms.

1. Introduction

This study aims to investigate whether the relationship between family firms and earnings management is influenced by the board independence. Earnings management has attracted much attention from both academics and practitioners in the last few years, arising as one of the major research in financial accounting and management (Chen, Lin, Wang, & Wu, 2010; Prencipe, Markarian, & Pozza, 2008; Shu & Chiang, 2014). Despite this wealth of research, little is known about earnings management in family business (Prencipe & Bar-Yosef, 2011). In fact, family firms are the prevalent form of business organization in different parts of the worlds. Perhaps, the most common form of family business ownership, is a family firm that is characterized by controlling owner(s) (Lubatkin, Ling, & Schulze, 2007). To the extent that ownership heterogeneity presents unique governance problems that distinguish them from widely held firms, family firms can provide an interesting platform to test issues relating to earnings management.

One of the characteristics of widely held firms is the separation of ownership from control, which gives rise to agency conflicts: the principal-agent (PA) conflicts between owners (principals) and managers (agents) (Jensen & Meckling, 1976). Because professional managers with superior information act as agents for owners, managers have incentives to report financial accounting information that deviates from the substance of underlying economic transactions in order to maximize private benefits at the cost of shareholders or creditors (Wang, 2006). In listed family-controlled firms, concentrated ownership reduces the traditional owner–manager conflicts because “the family's wealth is so closely linked to firm welfare, families may have strong incentives to monitor managers and minimize the free-riding problem inherent with small, diffused shareholders” (Anderson & Reeb, 2003: 1305). However, it has led to the

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development of a new agency conflict between minority shareholders and the controlling owners who serve as their potentially exploitative de facto agents. This is generally referred to as principal–principal (PP) conflicts (Miller & Le Breton-Miller, 2006; Morck & Yeung, 2003). Because the controlling owners oversee the accounting reporting policies and thus are perceived to have strong opportunistic incentives to limit accounting information that flows to the public and manipulate accounting earnings for private interests (Fan & Wong, 2002).

As Young, Peng, Ahlstrom, Bruton, and Jiang (2008) point out, PP conflicts are characterized by concentrated ownership and control, poor institutional protection of minority shareholders, and weak governance. Although prior empirical studies on U.S. and Italian corporations documented that founding family ownership is associated with higher earnings quality (Prencipe & Bar-Yosef, 2011; Wang, 2006), Fan and Wong (2002) suggest that the results from developed countries such as the United States may not be readily generalize into other parts of the world due to differences in the degree of ownership concentration and in institutional environment. Corporate ownership is highly concentrated in East Asia with weak legal systems, less transparent disclosure of financial reporting, and ineffective corporate governance mechanisms such as boards of directors (Chen & Huang, 2014; Fan & Wong, 2002). Thus, controlling owners have greater incentives to reduce earnings quality in East Asia than that in the United States.

Given the potential for principal–principal conflicts in family firms, this study empirically assesses the extent to which it actually exists in Taiwan's high-technology and listed family firms. Further, we also investigate the extent to which board independence limits earnings management. When the proportion of independent members on the board is high and the role of the chairperson is completely separated from the CEO (CEO nonduality), the board does strengthen its ability to monitor management objectively, thus reducing the likelihood of earnings management by family owners (Prencipe & Bar-Yosef, 2011). Hence, board independence in public-listed family firms is a theoretically important topic in the area of family business research. Taiwan represents an ideal setting to examine the effect of board independence on earnings management in family-controlled firms owing to its relative weak corporate governance, high ownership concentration, and abundance of family firm (Chen, 2014; Chu, 2011). Yeh, Lee, and Woidtke (2001) report that 76% of listed companies in Taiwan are controlled by family shareholders. In addition, Taiwan has achieved high levels of economic development since WWII, due largely to a national policy of promoting manufacturing in the information technology sector. High-tech firms such as Electronics and Electric and Machinery account for more than 60% of Taiwan listed companies (Chen & Liu, 2010). Therefore, high-tech industry plays a pivotal role in Taiwan. According to the statistics from the Taiwan Stock Exchange Corporation (TSEC), trading volumes from the information and electronics companies account for more than 39% of the total trading volumes in 2012. Moreover, high-tech companies are more dedicated in improving their corporate governance than are traditional companies (Lin, Kuo, & Su, 2008). Wang, Hsu, and Fang (2008: 1391) indicated that “the selection of independent directors has been the primary corporate governance objective for most prominent high technology institutional investors.” As a result, this analysis of Taiwan's high-tech firms allows us to study the impacts of family firms and board-monitoring role on earnings management in an institutional environment that differs noticeably from its counterpart in developed countries.

This paper is structured as follows. Section 2 describes the related literature review and research hypotheses. Section 3 presents the methodology. Section 4 reports the empirical results, and section 5 concludes the paper.

2. Theoretical background and research hypotheses

2.1. Family firms and earnings management

Although publicly listed family firms represent a significant part of the corporate sector in many developed and developing countries, there is little empirical study on them (Filatotchev, Lien, & Piesse, 2005, p.257). Family firms are present in one-third of the S&P 500 companies and Fortune 500 companies. In Western Europe, nearly half of the large firms are family controlled. Further, most developing economies in South American and East Asia, including Taiwan, are dominated by family-controlled firms. More than two-thirds of listed firms in East Asian countries are controlled by founding families or individuals (Chu, 2011).

Prior studies on family firms are based on agency theory and stewardship theory. Family firms may create agency problems different from nonfamily firms because the concentrated family-ownership can diminish traditional principal–agent conflicts. This can give rise to principal–principal conflict since family owners with unique opportunity may use their concentrated ownership to expropriate the earnings of minority shareholders. Contrary to the agency theory, the stewardship theory provides another perspective to understand family firms. Stewardship theory posits that family executives that act as stewards, rather than agents, believe their interests are aligned with that of the corporation and other shareholders (Davids, Schoorman, & Donaldson, 1997). Thus, family owners and managers often act with altruism for the benefit of the entire organization and its stakeholders other than economic self-interest. Indeed, family owners often have a deep emotional investment in their firms because their fortune, personal satisfaction, and even reputation are tied to the firm (Bubolz, 2001).

A recent study by Wang (2006) investigates the relationship between founding family ownership and earnings quality using the Standard & Poor's 500 companies. It indicates that family ownership could affect the supply of earnings quality in two competing ways: the entrenchment effect and the alignment effect. The entrenchment effect predicts that founding family ownership is associated with the supply of lower earnings quality, because the entrenched controlling owners may opportunistically manage earnings. It is consistent with the agency-theoretic view that concentrated ownership creates incentives for controlling shareholders to expropriate wealth from other shareholders. However, the users of financial statements may demand greater earnings quality for protecting their assets and interests if they suspect the potential entrenchment effect of family ownership. This motivates family firms to report higher-quality earnings. The alignment effect implies that interests of the controlling owners are aligned with that of other shareholders because founding families own large proportions of the shares and long-term presence in the firm. Therefore, founding