Ownership Structure and Corporate Social Performance

Chiung-Yao Huang, Assistant Professor, Dept. of Accounting & Information Systems, Asia University
Stephanie Wei-Ling Huang, Lecturer, Dept. of Foreign Languages & Literature, Asia University

ABSTRACT

Recent global financial scandals have brought to light the importance of corporate governance and related issues. The rights of investors and other stakeholders have thus become vital. As we seek to improve the internal governance mechanism and enhance actions of corporate social responsibility, the shortage of updated literature on non-financial social performance greatly hinders the transparency to the problems stated above, making tasks relatively challenging. In this research we focus on a common characteristic shared by many publicly listed Taiwanese companies whose control shareholders hold key management positions. In other words, a central agency problem between major and minor shareholders arises. The purpose of this study is to investigate whether ownership structure is a significant factor in corporate social performance. The empirical results indicate that when companies have more deviation between control rights and cash flow rights of control shareholders, they are more likely to have negative corporate social performance. In addition, companies that have more cash flow rights from control stockholders are less likely to encounter negative corporate social performance.

Keywords: Ownership Structure, Central Agency Problem, Corporate Social Performance

INTRODUCTION

By the late 1990s, the idea of corporate social performance had become almost universally sanctioned; it was promoted by all constituents in society from governments and corporations to non-governmental organizations and individual consumers (Lee, 2008). There are many international organizations such as the United Nations, the World Bank, the Organization of Economic Co-operation and Development and the International Labor Organization who make constant efforts in promoting Corporate Social Responsibility (CSR). Thus, the issue of corporate social performance has slowly gained a solid foothold in enterprises worldwide. For example, an investigation by Fortune Magazine demonstrated that since 1990, nearly 90% of the enterprises think that corporate social performance is the basic key element for organizational success. The magazine further indicated that CSR activities are widely included in their annual reports (Boli and Hartsuiker, 2001).

Throughout the past few decades, scholars have voiced different opinions regarding whether companies should be responsible for CSR activities, its targets, boundary and limits, or otherwise. Friedman’s (1970) main argument stated that the only responsibility a corporation had was to maximize profits for its shareholders. On the other hand, the father of CSR, Bowen (1953) thought that it was indeed obligatory for corporations to realize and execute all societal expectations. However, for the sake of sustainable development and long-term competitive advantage, enterprises should not only place shareholder’s interests first, but also fulfill their obligations and responsibilities for related stakeholders (Gray, 2000; Paine, 2003). This is also an important objective in strengthening the mechanism of corporate governance to mediate relevant stakeholders’ rights. The literature reveals that ownership structure is a major factor in agency problems between the management and external stockholders (Joh, 2003; Baek et al., 2004). In addition, CEOs are recognized as having extensive decision-making power and the ability to significantly influence their firm’s corporate social performance (Kochan, 2002; Orlitzky and Swanson, 2002).

The assumption of agency theory is that agents are self-interested (i.e., they have interests that diverge from those of the principals) and may attempt to maximize their interests at the expense of the principals’ (Eisenhardt, 1989). Based on agency theory, organizations can be analyzed in terms of conflict of interests between principals and agents (Jensen and Meckling, 1976). Agency theory is also commonly applied to the relationship of firm owners (principals) and managers (agents). This is a theoretical basis to describe the potential divergent and convergent interests between
managers and other stakeholders, which predicts how this not only affects corporate social performance, but also forms a common characteristic shared by many publicly listed Taiwanese companies with major shareholders holding key management positions.

According to the research by Fan and Wong (2002), in the seven Asian countries the average deviation between control rights and cash-flow rights is 0.85. However, in the case of Taiwan, this figure is 0.86, which is just behind Thailand and Hong Kong. We could conclude that Taiwan is a country with a high deviation rate. In other words, a central agency problem between major and minor shareholders is much more serious in Taiwan than in other countries because it is common for companies in Taiwan to increase the control rights of another public company through a cross-holdings strategy, pyramid ownership structures and shared collateralization (Yeh et al., 2001; Fan et al., 2002; Claessens et al., 2000).

As mentioned above, it is still too early to assess the performance of CSR under the unique structure of Taiwan enterprises (Claessens et al., 2000; Yeh et al., 2001). Therefore, this paper will focus on the special phenomenon in Taiwan’s listed companies to explore effects on the performance of CSR. We will use the theoretical integration among corporate governance, agency theory and CSR to support our argument.

The paper is organized as follows: First, we introduce the literature review and propose hypotheses. Next, we present the methodology including sample, data collection, research period and variables. Then, we provide the analysis of empirical results. Finally, we close with concluding remarks.

THEORY AND HYPOTHESES

This study explores the influence of ownership structure on corporate social performance toward stockholders and other stakeholders. Based on the related theories and prior empirical literature, we develop the hypotheses as follows.

Corporate Social Responsibility and Corporate Social Performance

A stakeholder view acknowledges concern for varied stakeholders, not just the firm’s shareholders. Wood (1991) defined corporate social performance as “a business organization’s configuration of principles of social responsibility, processes of social responsiveness, and policies, programs, and observable outcomes as they related to the firm’s societal relationships”. Therefore, corporate social performance has been advanced as an indicator of corporate operating performance more aligned with a stakeholder perspective.

Today’s business environment calls for both profitable and socially responsible management. Firms are under increasing pressure to embrace social responsibility because of the emerging standard (e.g. the International Organization for Standardization 9000 and 14000) and proliferation of independent evaluations and rankings that make social performance more transparent, such as the research databases of Kinder, Lydenberg, Domini, and Company (KLD) corporate social performance and its associated Domini Social Fund for investors to Business Ethics magazine’s “Best 100 Corporate Citizens” to the Social Investment Forum.

Furthermore, the essence of corporate governance lies in the ability to safeguard the interests of investors and other stakeholders. The continuous financial scandals of public companies in recent years in many countries, including Taiwan, have greatly raised concerns about the inadequacy of protecting investors and other stakeholders. In order to respond to these events and restructure the confidence of investors many countries have since introduced legislation and installed new monitoring bodies to improve financial reporting quality and enhance the protection for stakeholders. Thus, improving financial reporting quality and eliminating negative actions is an important and yet very challenging issue.

Whether a company violates regulations or acts illegally would be one way to evaluate a company’s corporate social performance. Since obeying the law and giving consistent information disclosure is the basic responsibility of a company, one should also look into other affairs such as global warming and environmental protection issues. A company should also try to avoid causing pollution under normal management. Thus, this paper targets discussions on negative corporate social performances from issues on environmental safety, disclosure of information, labor management relations and illegal aspects from the following four sectors.
1) Environmental and Safety Question
   Environmental pollution, illegal labor safety and public safety issues that arise during normal operation of a company. For example the fines from government or media’s disclosure on the emission of gas and waste produced due to insufficient regulations on work safety which jeopardizes public or consumers’ health or interests.

2) Information Disclosure Question
   Punishment and fines from authority due to untimely exposition or disclosure of information.

3) Labor Management Relationship
   Disclosure from media and/or authority on labor dispute or violations of labor rights and interests.

4) Other Violations and Illegal acts
   Other violations not categorized above but which were also punished or fined by authority or disclosed by the media.

The Relations Between Agency Problem and Corporate Social Performance
The importance of corporate social performance raises the question of whether managers are given incentives to improve the firm’s corporate social performance. There are two types of agency problem, namely the traditional agency problem and the central agency problem. The prior focuses on the condition of the separation of ownership from control rights; the lower the ownership of the managers, the higher possibility the traditional agency problem would be induced (Berle and Means, 1932; Jensen et al., 1976). Thus, it became a concerning issue as to whether the agent regards the maximization of principle wealth as the goal or is motivated by self-interest in the execution of business activity. This is a traditional agency problem in a capital market. However, the central agency problem, induced by the deviation of control rights from the cash flow rights of control shareholders, is different from the traditional agency problem. Since the control rights are held by control shareholders it would be difficult for minority shareholders and other stakeholders to take part in business operations. Thus the decision making process made by control shareholders would raise questionable doubts as to whether the outcome is of self-centered interest or for the overall benefit of shareholders.

Based on the findings of Claessens et al. (2000), Yeh et al. (2000), Chen and Hsu (2007), and Kao et al. (2006), it is very common for control shareholders in Taiwan listed companies to monopolize the rights of operating management and resource distribution. This paper focuses on the central agency problem that targets on the effects of control shareholders’ willingness to invest in CSR.

The Relations Between Ownership Structure and the Negative Corporate Social Performance
An organization requires a range of resources to conduct their business, such as capital, customers, employees, materials and legitimacy which are provided by stakeholders (Deegan, 2002). This creates a mutual obligation and a form of social contract, with stakeholders conceived of as providing a “license to operate” to the organization in return for their provision of socially acceptable, or legitimate actions (Cornelissen, 2004; Deegan, 2002; Golob and Bartlett, 2007).

The theoretical basis for the CSP-CFP relationship has yet to be unambiguously identified (Jawahar and Mclaughlin, 2001), and most of the published empirically studies of the relations between corporate social performance and corporate financial performance have shown a significant positive association over the long-term (Margolis and Walsh, 2003; Orlitzky et al., 2003). However, both strength and concern areas of corporate social performance require a long term commitment and continuous expenditure.

Making efforts in corporate social performance may not only have a direct negative effect on a firm’s short-term financial performance; it may further represent an opportunity cost for the CEO in that resources spent on improving the firm’s corporate social performance strengths represent resources not spent in maximizing short-term performance (Margolis et al., 2003). In addition, the negative financial effects of actions that result in corporate social performance concerns are not likely to be caught immediately. In contrast, actions of omission represented by corporate social performance concerns are more likely to affect the firm in the long run and thus provide little disincentive to the CEO in the short term (Short, 2004). This is why, in the traditional agency question, executives have a particular financial disincentive to engage in corporate social performance when their pay focuses on short-term incentives and job security.
Generally speaking, control shareholders often serve as the management and actually participate in business decision-making (the information advantage side), but minority shareholders and external stakeholders don’t (the information disadvantage side). The involvement of control stockholders will usually have a two-fold effect. In terms of negative effect, as long as control stockholders have management rights, the deviation between control rights and cash-flow rights are high, then selfish behavior and the motivation to invade stakeholders’ rights will become more prominent (Claessens et al., 2000; Yeh et al., 2001). Additionally, when the deviation between control rights and cash-flow rights became higher, the tendency and likelihood to commit more resources in protecting self-interest. Additionally, the relative cost and responsibility from bad operating performance could be apportioned to all shareholders, so control shareholders get a relatively low threat. This would be unfavorable for the promotion of corporate social performance (Dyer and Whetten, 2006). We propose that if firms have a higher degree of deviation between control rights and cash-flow rights of control stockholders, then a higher possibility of negative corporate social event would occur.

Hypothesis 1: The degree of deviation between the control rights and cash-flow rights of control stockholders and negative corporate social performance is positively related.

In terms of positive effect, if the control stockholders’ cash-flow rights are high, the result from successful management versus attractive profit will be consistent. Thus, it will greatly motivate and increase the efficiency of decision making and administration results (Anderson and Anthony, 1986; Finkelstein and D’Aveni, 1994). As stated above, if the control stockholders’ cash-flow rights are high, a positive incentive of managing good relations with stakeholders can be promoted. This is for the sake of the smooth operating of a firm, thus if we take our assumption from this point, then the likelihood of negative corporate social performance will decrease.

Besides, corporate social performance will influence the organization’s reputation, so investors will change cognition of company and the stock price will be affected (Orlitzky et al., 2003). If the cash-flow rights are higher, control stockholders will devote themselves to keeping good relationships with stakeholders in order to accumulate a business reputation by the activities of CSR. Whetten and Mackey (2005), Godfrey (2005), Trieschmann and Gustavson (1998) note that business reputations are conducive to accumulating moral capital, offering protection such as insurance and reducing the threat of punishment from stakeholders (Trieschmann et al., 1998). Consequently, control stockholders would tend to increase protection of their assets through promoting activities on corporate social performance.

Enterprises would encourage them to execute corporate social responsibility so as to establish invisible assets constituting good social citizens, including identification, image and reputation (Whetten et al., 2002; Whetten et al., 2005). In addition, to making stakeholders increase the accumulation of identification, positive impressions and business reputations on organization (Fombrun, 1996; Whetten et al., 2002), enterprises will have a higher tendency to execute CSR, which in turn would result in better corporate social performance toward stakeholders. To integrate with the above mentioned, while the cash-flow rights are high, control shareholders will possess a higher incentive to build up a good relationship with other stakeholders and reach less negative corporate social performance.

Hypothesis 2: The relationship between cash-flow rights of control stockholders and negative corporate social performance is negative.

METHOD

This section will report the research design in detail, including samples, data collection, sample period and selection.

Sample and Data

The study collected research data from 2004 to 2008 from the public listed companies in Taiwan. The financial data are all from the Taiwan Economic Journal (TEJ) database. Negative social event data are obtained from Daily important news released by public companies of the Market Observation Post System and Point Recordation Lists of
disciplinary actions or defects on the Stock Exchange and OTC Center’s news. Economic Daily News, Commercial Times and other public information. There are 2,824 sample companies included in this study.

Measures

This paper explores the relationship between ownership structure and negative corporate social performance. In the perspectives of entrenchment and incentives about control stockholders, we focus on the characteristics of ownership structure and on the deviation between control rights and cash-flow rights of control stockholders, and the cash-flow rights held by control stockholders.

Ownership structure (denoted as DEV; CF). In regard to mandated securities central depository of large shareholders in Taiwan, large shareholders with control rights intend to use external power to obtain more Board Seats on the board of directors to increase control rights and participate in decision-making. That is the reason why traditional control rights of shares can’t exactly measure the level of control by control shareholders. We measure the first type of ownership structure (denoted as DEV) as the deviation between Board Seats ratio and cash-flow rights ratio of control stockholders. The second type of ownership structure (denoted as CF) as the cash-flow rights held by control stockholders.

Negative Corporate social performance (denoted as NCSP). A broad definition of corporate social performance is consistent with the stakeholder concept (Freeman, 1984), which suggests that organizations are accountable to a wide audience such as employees, customers, local communities and government, in addition to shareholders. In this paper we uses dummy variables to measure the negative social events, including environmental and safety questions, information disclosure questions, Labor Management Relationships, and other violations and illegal acts, as the proxy for negative social performance. NCSP=1 if there is a negative event revealed in a year, and 0 otherwise.

Control variables. We control for the size of the board of directors, external independent directors’ seats because both have potential links to corporate social performance and have been commonly specified in previous studies of corporate social performance. Research has not achieved consensus on the idea whether the size of boards are associated with better performance or not. Jensen (1993), for example, suggested that “When boards get beyond seven or eight people they are less likely to function effectively and are easier for the CEO to control”. This view is in contrast to that of Lorsch and MacIver (1989) whose study states that many directors are themselves CEOs: “CEOs have the most relevant experience and expertise to be effective directors. CEOs understand the complex problems of running a major enterprise and, it is argued, provide the best counsel and advice”. For the above reasons, we don’t anticipate the sign of board size.

General speaking, on the behalf of outside shareholders’ interests, the status of independent directors is more independent and of less self-interest, so they can assess the management decisions by making impartial supervision and objective decisions (Davis, 1993). Regarding the perspective on monitoring hypothesis, the board of directors with independent directors would monitor and control the opportunistic behavior of other directors and the management so as to promote corporate performance (Jensen et al., 1976). Thus, we expect the sign between independent directors’ size and negative corporate social performance to be negative.

To sum up, this study includes the size of the board of directors, seats of external independent directors in the logistic regression as control variables. They are defined separately as follows:

1. the size of the board of directors (denoted as BS):
   \[ BS = \text{the number of the board of directors} \]

2. external independent directors’ seats (denoted as EID):
   \[ EID = \text{the number of external independent directors} \]

RESULTS

A summary of descriptive statistics and a correlation matrix for selected variables are provided in Table 1. The mean deviation between control rights and cash-flow rights of control stockholders is 39.1244%. The mean of the cash-flow rights held by control stockholders is 23.3706%. These means control shareholders affect a corporation
through actual participation in operating management. This result is consistent with prior literature (e.g. Claessens et al., 2000). Furthermore, the mean of Negative Corporate social performance is 0.1484. The size of the board of directors is larger than the most efficient size, such as Lipton and Lorsch (1992) and Jensen (1993) who argue that when the number of directors is over 7-8 persons, the efficiency of the board will be reduced. Finally, the mean of the number of external independent directors is larger than 1 and the standard deviation is 1.48574. This is a result of compulsory legislation.

### Table 1: Descriptive Statistics and Pearson Correlation Matrix

<table>
<thead>
<tr>
<th>Variables</th>
<th>Mean</th>
<th>Std. Dev.</th>
<th>DEV</th>
<th>CF</th>
<th>NCSP</th>
<th>BS</th>
<th>EID</th>
</tr>
</thead>
<tbody>
<tr>
<td>DEV</td>
<td>39.1244%</td>
<td>24.58635</td>
<td>1</td>
<td>-0.506(**)</td>
<td>0.101(**)</td>
<td>0.048(*)</td>
<td>-0.375(**)</td>
</tr>
<tr>
<td>CF</td>
<td>23.3706%</td>
<td>16.88484</td>
<td>-0.506(**)</td>
<td>1</td>
<td>-0.505(**)</td>
<td>-0.148(**)</td>
<td>-0.070(**)</td>
</tr>
<tr>
<td>NCSP</td>
<td>0.1484</td>
<td>0.35553</td>
<td>0.101(**)</td>
<td>-0.505(**)</td>
<td>1</td>
<td>0.140(**)</td>
<td>-0.079(**)</td>
</tr>
<tr>
<td>BS</td>
<td>9.9812</td>
<td>3.14475</td>
<td>0.048(*)</td>
<td>-0.148(**)</td>
<td>0.140(**)</td>
<td>1</td>
<td>0.051(**)</td>
</tr>
<tr>
<td>EID</td>
<td>1.1151</td>
<td>1.48574</td>
<td>-0.375(**)</td>
<td>-0.070(**)</td>
<td>-0.079(**)</td>
<td>0.051(**)</td>
<td>1</td>
</tr>
</tbody>
</table>

N=2824

**p < 0.01; *p < 0.05; (2-tailed).

DEV: the deviation between control rights and cash-flow rights of control stockholders
CF: the cash-flow rights held by control stockholders
NCSP: Negative Corporate social performance
BS: the size of the board of directors
EID: external independent directors’ seats

We test our hypotheses with Binary Logistic regression analysis and present the summary in Table 2. Our Binary Logistic regression from Model 1 shows the deviation between control rights and cash-flow rights of control stockholders (denoted as DEV) is, as expected, positively associated with negative corporate social performance, and the coefficients are statistically significant at the .001 level. As the deviation between control rights and cash-flow rights took place, available benefit is much larger than the cost as a result of expropriating minority shareholders and lessening resource investment in other stakeholders. This result consists of not only the research expectation but also the argument of entrenchment hypothesis (Claessens et al., 2002; La Porta et al., 1999; Shleifer and Vishny, 1997). Thus, hypothesis 1 is supported and we can reach an 85.0% estimation on classification accuracy ratio using model 1.

Model 2 is a Binary Logistic regression that shows that the cash-flow rights (denoted as CF) held by control stockholders is, as expected, negatively associated with negative corporate social performance, and the coefficients are statistically significant at the .001 level. As the cash-flow rights of control stockholders increase, the goal of long-term operating is consistent with self-interests. Hence, control stockholders have incentive to reduce negative corporate social responsibility into action and transmit these messages to stakeholders, creating deeper trust and commitment to the firm. Hypothesis 2 is also supported. The classification accuracy ratio of model 2 is 85.2%.

The coefficient of the size of the board of directors is also positive and statistically significant at the .001 level. As the size of the board increases, the control stockholders are less likely to be concerned about corporate social responsibility. Finally, the coefficient of external independent directors’ seats is, as expected, negative and statistically significant at the .001 level. This reveals that the role of external independent directors can be used to protect the interests of all stakeholders.

### Table 2: Binary Logistic regression results of ownership structure on negative social performance

<table>
<thead>
<tr>
<th>dependent variable</th>
<th>Model (1)</th>
<th>Model (2)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intercept</td>
<td>-3.052</td>
<td>-2.457</td>
</tr>
<tr>
<td>Independent variable</td>
<td></td>
<td></td>
</tr>
<tr>
<td>DEV</td>
<td>.009***</td>
<td></td>
</tr>
<tr>
<td>CF</td>
<td></td>
<td>-.007***</td>
</tr>
<tr>
<td>Control variables</td>
<td></td>
<td></td>
</tr>
<tr>
<td>BS</td>
<td>.102***</td>
<td>.101***</td>
</tr>
</tbody>
</table>

Notes: NCSR - negative corporate social responsibility

(1) t-test (2) t-test
**SUMMARY AND CONCLUSIONS**

The empirical results indicate that when companies have more deviation between control rights and cash-flow rights, control stockholders are less likely to manage the relations of minor stockholders and other stakeholders. Such behavior is probably conducted for control stockholders’ self-interests. The results also show that as the cash-flow rights of control stockholders increase, the less negative corporate social performance is. One explanation is that control stockholders would be more concerned about long-term operating and development and, therefore, engage themselves in more corporate social activities. Furthermore, control stockholders have the resources and abilities to carry out effective corporate social activities for the firm. The behavior of negative events will be inhibited.

The purpose of this study is to investigate whether the ownership structure is a significant factor in corporate social behavior. We provide evidence of the role of the deviation between control rights and cash-flow rights of control stockholders in negative corporate social performance. The data set is from the emerging market of Taiwan. Unlike the traditional agency problem between managers and outside shareholders that was first exposed in Berle et al., (1932) and has since been examined extensively in the literature, this study examines the central agency problem between major and minor shareholders. Through this effort, the study represents a first attempt to examine empirical evidence on the relationship between entrenchment and incentives of control stockholders and corporate social performance in Taiwan. The results obtained here should be of interest to investors, financial statement users, regulators and the government.

**REFERENCES**


