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The effect of intrafamily agency conflicts on audit demand in private family firms: The moderating role of the board of directors

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ABSTRACT

While the value of external audits was long considered to be minimal for private family firms, some exceptional studies indicate that external audits are demanded by these firms to reduce the agency conflicts between family and non-family members. Using a sample of Belgian private family firms, this study empirically shows that (high quality) auditors are also hired to mitigate agency conflicts *among* family members. Since these *intrafamily* agency conflicts are mainly based on emotions instead of economically rational behavior and are therefore difficult to grasp by compositional proxies, they are identified by the level of family cohesion. Moreover, this study shows that the monitoring effectiveness of the board of directors weakens the association between the level of intrafamily agency conflicts and audit (quality) demand, indicating that the audit demand effect of intrafamily agency conflicts decreases when family firms are able to reduce the related agency costs internally.

1. Introduction

Audit demand is generally explained by agency theory, which considers auditing as one of the main devices to mitigate agency conflicts. By verifying the validity of the financial statements, an auditor is considered to be able to reduce the related agency costs as this verification reduces the information asymmetries between the firm's stakeholders and therefore limits the possibilities for managers to behave opportunistically (Becker, Defond, Jiambalvo, & Subramanyam, 1998). Based on agency theory, many studies investigating listed firms have found the level of agency conflicts to be the main driver of demanding an (high quality) audit (e.g. Fan & Wong, 2005; Firth & Smith, 1992; Francis et al., 2009; Francis & Wilson, 1988; Liu & Lai, 2012; Piot, 2001; Reed et al., 2000).

Traditional agency theory predicts only a limited level of agency conflicts in private and especially private family firms due to more concentrated ownership and closer relationships, which already decreases the possibilities as well as the incentives for managers to behave opportunistically towards others (Fama & Jensen, 1983a, 1983b; Jensen & Meckling, 1976). Therefore, audit demand studies in a private (family) firm context, are scarce. However, agency problems do also occur in private family firms. First, agency conflicts can arise between family and non-family members due to different opinions regarding the firm's goals, family employment, and other issues (Schulze, Lubatkin, Dino, & Buchholtz, 2001). This may lead to a demand for auditing in private family firms as well, which is also confirmed by some exceptional studies (Carey, Simnett, & Tanewski, 2000; Collis et al., 2004; Collis, 2012; Niemi, Kinnunen, Ojala, & Troberg, 2012; Niskanen, Karjalainen, & Niskanen, 2010). Second, agency conflicts can also prevail *within* the family (Blanco-Mazagatos, De Quevedo-Puente, & Castrillo, 2007; Gomez-Mejia, Nuñez-Nickel, & Gutierrez, 2001; Schulze et al., 2001).

These intrafamily agency conflicts may result from the fact that family relationships are generally based on emotions and the agency theory's assumption of economically rational behavior will therefore not hold (Gomez-Mejia et al., 2001; Schulze, Lubatkin, & Dino, 2003a; Schulze et al., 2001). Among others, potential causes of such intrafamily agency conflicts may be the protection-autonomy clash between parents and offspring, sibling rivalry or emotional conflicts between parents (Nicholson, 2008a, 2008b). For example, family members may become *dissatisfied* about their role in the family firm and turn *jealous* of other family members, which may lead to opportunistic behavior (Sharma, Chrisman, Pablo, & Chua, 2001).

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As intrafamily agency conflicts can arise in family firms, they may also increase the demand for an (high quality) auditor to reduce the related agency costs. More specifically, by verifying the financial statements, (high quality) auditors may discourage family members to behave opportunistically and 'de-emotionalize' potential conflicts by providing all family members with objective financial information that would enable them to make more rational business decisions. Therefore, we want to add to the aforementioned studies that only focused on the agency conflicts between family and non-family members by examining the relationship between the level of these intrafamily agency conflicts and audit demand.

Moreover, since one of the main roles of a firm's board of directors is monitoring and controlling management in order to reduce agency costs (Eisenhardt, 1989; Fama & Jensen, 1983b; Zahra & Pearce, 1989), an effective monitoring board could also be considered as an instrument on which a family firm could rely to mitigate the level of intrafamily agency costs (Bammens, Voordeckers, & Van Gils, 2010). More specifically, effective monitoring boards will focus on providing the different family units with objective information and controlling the behavior of family managers to ensure that the interests of all family owners are being served (Bammens, Voordeckers, & Van Gils, 2008; Bammens et al., 2010; Steier, 2001). Because these tasks partly overlap with the tasks of the external auditor and serve the same goal (i.e. reducing intrafamily agency costs), the demand effect of intrafamily agency conflicts on audit demand might be moderated by the monitoring effectiveness of the board. Since privacy and confidentiality are considered to be two of the most important values for family firms (Lester & Cannella, 2006; Su & Dou, 2013), which will especially be the case regarding intrafamily agency conflicts, a family firm may consider the need for an (high quality) auditor to be lower when already having an effective monitoring board of directors that is able to mitigate these agency conflicts or at least the negative consequences of these conflicts (i.e. the agency costs) internally.

Using questionnaire data of Belgian private family firms, we are able to grasp both the emotion-based intrafamily agency conflicts and the board's monitoring effectiveness without having to rely on compositional measures that are not able to fully take into account the heterogeneity and behaviors of/in private family firms. More specifically, we rely on family cohesion as a (negative) indicator for the intrafamily agency conflicts as it is defined as "... the emotional bonding that family members have towards one another" (Olson, 2000; p. 145) and is considered to be negatively associated with the extent to which interests among family members diverge (Olson, 2000) and thus the level of intrafamily agency conflicts. We thereby only focus on the agency conflicts that are the result of diverging interests among family members. In line with Chrisman, Chua, and Litz (2004), we do not consider the pursuit of non-economic goals at the expense of firm value to be intrafamily agency conflicts if the family members have consensus regarding these goals. In order to measure the monitoring effectiveness of the board, we rely on the board effectiveness scale of Minichilli et al. (2009) instead of the frequently used compositional measures that proxy independence as recent studies (Bammens et al., 2010; Zona, 2015) argue that board performance cannot simply be inferred from such measures. In line with most other audit demand studies that examine a similar context (e.g. DeFond, 1992; Francis & Wilson, 1988; Niskanen et al., 2011; Piot, 2001), we focus on audit *quality* demand instead of *voluntary* audit demand since the criteria to be legally required to hire an auditor are rather low in Belgium and voluntary audit demand is therefore rare. More specifically, firms with little or no need for auditing are expected to engage a cheaper non-Big4 auditor in order to fulfill the legal requirement in the most cost-effective way while the more expensive Big4 auditors will be mainly demanded by firms who have a higher actual (economic) need for auditing (Willekens & Achmadi, 2003).

Our results confirm that the level of intrafamily agency conflicts is also a determinant of audit demand, although this demand effect is weaker when having an effective board of directors that is able to reduce the related agency costs internally. These findings add significantly to the knowledge we have about the role of auditing in private family firms in three ways. First, while this role was long considered to be minimal, recent studies show that auditing might be valuable for private family firms but only limited this value to reducing agency conflicts between family and non-family members. The present study indicates that an external audit should also be considered as an important mechanism to reduce the level or at least the negative consequences of the intrafamily agency conflicts. Second, as intrafamily agency conflicts are mainly based on emotions instead of rational behavior, we identify these agency conflicts by measuring the extent of family cohesion and in this way answer the call of Kellermanns et al. (2014) to integrate concepts of other fields in the family firm literature to advance our understanding about how emotions may influence strategic decisions. Third, this study sheds light on the role of the board of directors within the audit demand curve in this specific context, by which we contribute to the limited knowledge we have about how the several monitoring mechanisms may influence each other, especially regarding the mitigation of intrafamily agency conflicts.

The remainder of this article proceeds as follows. In the next section, we give a brief overview of past audit demand literature, after which we develop testable hypotheses related to the influence of intrafamily agency conflicts and the monitoring effectiveness of the board on audit demand in private family firms. Section 3 describes our data and methodology. Our results are presented in section 4 and our conclusions can be found in section 5.

2. Theory and hypotheses

2.1. Audit demand in private family firms

A considerable amount of literature has been published on audit demand, which includes both the voluntary demand for an auditor (e.g. Carey et al., 2000; Chow, 1982; Niemi et al., 2012) and the demand for audit quality (e.g. DeFond, 1992; Francis & Wilson, 1988; Niskanen et al., 2011; Piot, 2001). Voluntary audit demand studies focus on firms that are not required by law to have their financial statements audited (e.g. private firms in the USA) and therefore examine the drivers for the voluntary appointment of an auditor. Audit quality demand studies focus on firms that are already required by law to hire an external auditor (e.g. listed companies, larger private companies in European countries, etc.) and therefore examine the drivers for hiring a high quality auditor. Although the present study actually relates to the second group of audit *quality* demand studies, both voluntary audit demand and audit quality demand are based on the same theoretical framework.

More specifically, audit demand studies generally rely on agency theory to explain the demand for voluntary or high quality auditing. Agency theory considers both the owners and managers of a company to be utility maximizers. In order to maximize their own utility, managers (the agents) will not always act in the best interest of the owners (the principals), which leads to agency costs (Jensen & Meckling, 1976). Principals will try to limit divergences from their interest by monitoring and contracting (e.g. management compensation contracts based on performance) (Jensen & Meckling, 1976; Lennox, 2005). These activities, however, often rely on the accounting numbers. Since these are generally prepared by management, there is information asymmetry between the