ARTICLE IN PRESS

Journal of Family Business Strategy xxx (xxxx) xxx–xxx

Contents lists available at ScienceDirect

Journal of Family Business Strategy

journal homepage: www.elsevier.com/locate/jfbs

The impact of family influence on financial reporting quality in small and medium family firms

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ARTICLE INFO

Keywords:
Family firms
Family influence
Financial reporting
Earnings management
F-PEC

ABSTRACT

In this study, we investigate whether accounting information quality is affected by the special characteristics of small- and medium-sized family firms. These companies have a particular power and management structure and different stockholder interests, compared to large companies. We go a step further than prior literature and use a multidimensional approach based on the Family Influence on Power, Experience, and Culture (F-PEC) scale to assess heterogeneity among family firms. Additionally, we develop a comprehensive approach that considers discretional accruals, real earnings, and accounting information quality measurements such as conservatism and earnings persistence. Our findings, based on a sample of 252 small- and medium-sized Spanish family manufacturing firms, show that the 'Power' dimension decreases the quality of financial reporting, whereas 'Experience' promotes earnings persistence and conservatism; finally, 'Culture' curbs earnings management in terms of real earnings and favours both earnings persistence and conservatism. Consequently, according to our results, family businesses that resemble our sample firms should promote family involvement in terms of culture and experience, while limiting power inside the company.

1. Introduction

Previous studies have shown that family businesses are different from non-family firms in many aspects, including management style, decision-making processes, long-term orientation and profitability (Wagner, Block, Miller, Schwens, & Xi, 2015). Their family character and the family-company relationship provide family businesses with unique traits and culture that have a number of advantages over non-family businesses (Discua Cruz, Hamilton, & Jack, 2012; Frank, Lueger, Nosé, & Suchy, 2010). The existence of 'intangible assets', such as the degree of family dedication and commitment to the business, tacit and specific knowledge of doing business, and the existence of an inimitable culture are often-cited sources of competitive advantage (Chirico, 2008; Miller & Breton-Miller, 2006; Sirmon & Hitt, 2003; Zahra, Hayton, Neubaum, Dibrell, & Craig, 2008). Indeed, the interaction between family and business subsystems paired with family unity can create synergy that favours family business performance (Habbershon, Williams, & MacMillan, 2003).

In the family business research literature, there is a line of research that studies accounting manipulation, earnings management, and financial information disclosures (Carney, Van Essen, Gedajlovic, & Heugens, 2015; Cascino, Pugliese, Mussolino, & Sansone, 2010; Drago, Ginesti, Pongelli, & Sciascia, 2018; Ferramosca & Allegrini, 2018; Paiva, Lourenço, & Branco, 2016; Sousa, Costa & Castelo, 2016). This line of research has mostly been developed through studies comparing differences in behaviour between family and non-family firms and, in most cases, with publicly listed companies (Liu, Shi, Wilson, & Wu, 2017; Stockmans, Lybaert, & Voordeckers, 2013). Most of these studies focus mainly on the hypotheses of entrenchment and the assumption of an alignment between family property and the management function under an agency theory framework (Wang, 2006). However, in an organization in which non-financial objectives prevail and behaviour may not always be economically rational, as is often the case in family firms (Cabrera-Suárez, Déniz-Déniz, & Martín-Santana, 2014), the explanatory power of agency theory may be more restricted (Le Breton-Miller, Miller, & Lester, 2011; Prencipe, Markarian, & Pozza, 2008).

Because most corporate governance research has focused on larger firms, more studies on small- and medium-sized privately held family firms are necessary (Vieira, 2016). Furthermore, only a few studies in earnings management focus on these types of companies (Paiva et al., 2016; Pazzaglia, Mengoli, & Sapienza, 2013), despite their importance in the economy and the awareness that earnings management is an

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https://doi.org/10.1016/j.jfbs.2018.08.002

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Please cite this article as: Duréndez, A., Journal of Family Business Strategy (2018), https://doi.org/10.1016/j.jfbs.2018.08.002

important issue in private family firms (Stockmans, Lybaert, & Voordeckers, 2010). In addition, most previous studies have focused on analysing the differences between family and non-family businesses. However, within the group of family businesses, there are still differences that have not been previously analysed, i.e. governance- and/or resource-related differences, considering the heterogeneity in family firms (Astrachan, 2010; Nordqvist, Sharma, & Chirico, 2014). According to Chua, Chrisman, Steier, and Rau (2012), these previous studies comparing family versus non-family firms are based on the assumption that family firms are homogeneous organizations.

We aim to fill the gap, identified by Tong (2007) and Sousa et al. (2016), in the lack of evidence pertaining to earnings management in different types of family firms, specifically in non-listed family firms. Therefore, we test how the F-PEC dimensions (power, experience and culture) (Astrachan, Klein, & Smyrnios, 2002) affect the quality of financial reporting by family firms. To test this hypothesis, we based our research on a multidimensional approach to measure the heterogeneity among private small- and medium-sized family firms (Chua et al., 2012) and used a comprehensive approach to earnings management practices (discretionary accruals and real earnings) and accounting information quality (earnings persistence and conservatism). This paper's contribution is particularly relevant because we use the robust methodological advantage of combining both multi-dimensional family influence information (F-PEC dimensions) and financial reporting data in a single study.

Our results contribute new and original evidence to family firm research, showing that because earnings management tends to reverse over time, the long-term focus of family firms should ultimately result in less earnings manipulation. Therefore, the family firm culture curbs earnings management in terms of real earnings and favours both earnings persistence and conservatism. Indeed, when the family firm develops values related to positive commercial behaviour—a desirable reputation for both the family and firm, and a sense of responsibility for future generations—the quality of accounting information is higher. On the other hand, the power variable is shown to decrease the quality of accounting information in family firms. Moreover, family power in terms of management and the board of directors decreases earnings persistence and accounting conservatism. Finally, the experience dimension reveals that increasing the degree of experience, in terms of the involvement of the founder and various family generations in the business, raises the persistence of earnings as well as conservatism in relation to accounting and accounting information quality. These results fill a gap in the literature regarding the relationship between family firms and earnings management. Whereas previous literature has focused exclusively on the relationship between family firms and accrual-based earnings management (Prencipe & Bar-Yosef, 2011), the present study goes a step further by providing a comprehensive approach using real earnings management and accounting information quality measurements such as conservatism and earnings persistence.

The remainder of this article is organized as follows. Section 2 provides a brief explanation of the theoretical basis for the approach adopted in this study. Section 3 presents information on the sample and the methodology used to analyse the data. Sections 4 and 5 reveal the results of the analysis and discuss them, respectively, and Section 6 concludes.

2. Quality of financial reporting considering family influence

Most previous studies in the literature on earnings management in family firms have focused on family companies listed in stock markets (public companies). In this case, the previous literature has been devoted to the agency problem between majority and minority shareholders identified within the context of agency theory (Jiraporn & DaDalt, 2009), as well as the hypothesis of alignment (Wang, 2006).

Within the framework of agency theory, according to Prencipe et al. (2008), agency conflicts are deeper in listed family companies because, in family firms, the agency problem is not so much related to information asymmetry between owners and managers, as that between large and minority shareholders; there also exists the problem of entrenchment of ownership by large insiders.[1] Fan and Wong (2002) stated that when ownership is highly concentrated, large shareholders also control the quality of accounting information and its level of disclosure. These authors found that the higher the concentration of ownership, the lower the quality and transparency of the results. In this regard, Tong (2007) found that family businesses adopted better quality accounting disclosures in accordance with a long-run investment horizon, greater concern about their reputation, and less opportunistic rent-extraction activities.

According to Paiva et al. (2016), prior literature has focused on the reporting practices of family versus non-family firms in the context of listed firms. Consequently, there are no studies investigating the reporting practices of private small- and medium-sized family firms controlling for their structural differences with public listed family firms. Following this reasoning, the findings may not be similar for non-listed family firms because listed companies face very different incentives for earnings management. Particularly in the case of listed family businesses, disclosure requirements demanded by stock market supervisors, along with the quantity and quality of the required accounting information, allow for fewer opportunities for accounting information manipulation than within unlisted private family firms. In contrast, small- and medium-sized family firms do not have to comply with certain standards of reporting, potentially making them less transparent and allowing them to control the quality of their accounting information (Fan & Wong, 2002).

In the particular case of family businesses, research on earnings management and accounting practices should therefore be studied from a different perspective than the traditional approach of comparing listed family firms and listed non-family firms. This is because of the heterogeneity of family firms. Furthermore, Chua et al. (2012), Pazzaglia et al. (2013) and Stockmans et al. (2013) considered that within non-listed family firms, earnings management depends on specific types of family firms, varying according to generational stage, management teams, CEO position, and the composition of the board of directors. Their reasoning is based on the argument that the relationship between the characteristics of the board of directors and accounting manipulation practices is moderated by the potential presence of agency conflicts (Paiva et al., 2016).

We develop, in the context of small- and medium-sized family unlisted companies, several research hypotheses, taking into consideration the main characteristics that identify family business involvement, included in the concept of 'familiness' proposed by Habbershon and Williams (1999). This definition measures the unique resources possessed by family businesses due to the interaction effect between the family and the business. With this intention, we consider heterogeneity across family firms through a multidimensional approach based on F-PEC dimensions that reflect the nature of the family business in terms of family power, experience and culture (Astrachan et al., 2002). As we only focus on analysing the behaviour of non-listed small and medium family firms, we overcome the prior limitations of the dichotomous classification of companies into family and non-family firms by approaching the research through a multidimensional model of family influence on earnings management (Frank et al., 2010). The F-PEC scale of family influence provides a theoretically robust and empirically verified concept that enables us to explore the effect of family influence on the reporting practices of various types of family firms and analyse the sources of their heterogeneity more coherently and effectively.

[1] For an overview of the literature on so-called secondary agency conflicts, please refer to Sutton, Veliyath, Pieper, Hair, and Caylor (2017).

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