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Real earnings management in family firms: Evidence from an emerging economy☆

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We examine the relationship between family ownership and real earnings management in an emerging economy context, Bangladesh. Existing literature reports evidence of minority expropriations by the controlling shareholders in weaker investor protection environments. Based on that argument, we hypothesize and provide evidence that family firms in Bangladesh engage in more real earnings management (REMs) compared to non-family firms during the period 2006-2011. Moreover, we obtain evidence of existence of curvilinear relationships between family ownership and REMs. In Bangladesh, family firms manifest higher level of REMs at a relatively earlier stage of ownership concentration and this pattern reverses once family ownership passes a certain ownership threshold. In addition, we also provide evidence that REMs are associated with lower future performance.

1. Introduction

Prior studies examine earnings quality of family firms focusing on accruals earnings management (Ali et al., 2007; Ding et al., 2011; Fan and Wong, 2002; Wang, 2006). Graham et al. (2005) provide evidence that managers prefer real earnings management (REMs) activities compared to accrual-based earnings management. Roychowdhury (2006) finds that firms use multiple REMs tools in order to meet certain financial reporting benchmarks to avoid reporting annual losses. Surprisingly, there is a paucity of research on family firms' engagement in REMs despite the fact that family firms offer an interesting experimental setting for the investigation of REMs engagement. On the one hand, it may be argued that the activities that result in REMs are more easily facilitated in family firms. On the other hand, the potential adverse effect of deviating from regular operational and investment activities may act as a deterrent to REMs in family firms.

A recent study by Achleintner et al. (2014) in the German context provides evidence that family firms are less likely to engage in REMs, which is perhaps indicative of the fact that family owners are less likely to jeopardize the long term prospects of their investments in the firms. However, this finding may not be generalizable in contexts that substantially differ from Germany. On the other hand, it has also be shown that insiders are more likely to engage in earnings management to facilitate their private benefit consumptions in weaker investors' protection regime (Leuz et al., 2003). Hence, the issue of REMs in family firms in a weaker investor protection environment merits empirical investigation. Accordingly, we examine whether family firms engage in REMs in Bangladesh. Further, we examine whether a curvilinear relationship exists between family ownership and the level of REMs and whether engaging in REMs results in lower future profitability or not in the Bangladesh context.

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Extant literature observes contrasting findings with regard to earnings quality in family firms. One strand of research argues that family firms demonstrate better earnings quality compared to non-family firms (Ali et al., 2007; Wang, 2006), while Claessens et al. (2002) and Fan and Wong (2002) contend that family firms generally have lower quality accounting information. This lack of generalizability of the findings on earnings quality in family firms mostly revolves around the accruals earnings management measurements. However, there is evidence that earnings management is not limited to accruals management only but may involve real earnings management (Cohen et al., 2008; Cohen and Zarowin, 2010; Graham et al., 2005; Gunny, 2010; Roychowdhury, 2006; Zang, 2012). Real earning management (REMs) involves manipulation of real activities to meet some earnings benchmark that may result in sub-optimization of firm's resources. REMs has its impact on firm's cash flows (Roychowdhury, 2006) and it is less susceptible to external scrutiny.

Family firms offer an interesting avenue for investigation of REMs. Family owners are often active managers in the firms (Anderson and Reeb, 2003), and hence, may enjoy greater latitude in altering regular operational and investment activities. Such actions are less likely to be contested by the professional managers since they serve the family interests (DeAngelo and DeAngelo, 2000). Accordingly, the REMs, achieved through alteration of regular operational and investment decisions, may turn out to be a more convenient option for family firms. However, this facilitation may be negated by the concern for potential adverse impact of REMs (Cohen and Zarowin, 2010; Graham et al., 2005; Roychowdhury, 2006). Family owners are less likely to manifest myopic and value decreasing actions due to their long run investment horizon in family firms (Stein, 1989). As such, the issue of REMs in family firms is a compelling one to examine empirically. Despite this, REMs in family firms is heavily under researched.

The issue of REMs in family firms may be of greater interest in weaker investor protection regimes. The poor legal protection for investors has been found to be positively related to poor quality reported earnings (Leuz et al., 2003). Insiders are more likely to acquire private benefits in such environment and this in turn induces them to manage earnings to conceal their activities (Leuz et al., 2003). The question of REMs in family firms becomes even more intriguing under such circumstance. Our study is carried out in a developing economic context, namely Bangladesh, which bears the characteristics of having a relatively weaker investor protection regime including underdeveloped capital markets (Siddiqui, 2010). With the dominant presence of family ownership (Farooque et al., 2007a; Muttakin et al., 2014; World Bank, 2009), the possibilities of private rent seeking activities of family owners are higher with the existing frailties in Bangladesh's governance environment. Hence, the question of REMs in family firms in the context of Bangladesh is worthy of examination.

Moreover, the Bangladesh Securities Exchange Commission (BSEC) makes it mandatory for the sponsors/promoters and directors of listed companies to hold 30% of total paid-up share capital in aggregate (Bangladesh Securities and Exchange Commission, 2011). Most of the sponsor directors in listed companies of Bangladesh belong to families that hold controlling shares in those companies (World Bank, 2009). Accordingly, the BSEC's decision will likely result in higher concentration of ownership in the hands of controlling families. Moreover, this stipulation should result in long-term investment horizon since the cumulative equity holdings by the sponsors/promoters and directors are required to be at least 30% at all times. Given the fact that the consequence of concentrated ownership on firms' earnings management remains unexplored in Bangladesh, the finding of our study provides an ex-ante analysis of this mandated ownership with regard to the impact of family ownership concentration on REMs.

The extant literature on family firms provides evidence that family ownership has non-monotonic relationship with accruals earnings management (Wang, 2006). Wang (2006) documents that there remains a nonlinear or curvilinear relationship between family ownership and earnings quality measured by abnormal accruals. This supports his argument that earnings management in family firms is an empirical issue since it depends on the relative influence of alignment and entrenchment effects. In a similar vein, we argue that the magnitude of REMs in family firms may also exhibit a curvilinear pattern. Interestingly, to date no study attempts to explore the curvilinear relationship between family ownership and REMs. Our study makes an effort to fill this gap through investigating the nonlinearity of the relationship between family ownership and REMs in a developing economic context.

Modifications to regular operational and investment activities are argued to have negative consequences if resulting from opportunistic managerial actions (Cohen and Zarowin, 2010; Graham et al., 2005; Roychowdhury, 2006). However, these modifications may not always bring negative future consequences if such modifications are the outcomes of efficient managerial actions (Gunny, 2010). We hypothesize that the modifications of activities are more likely to be the effect of opportunistic managerial actions in Bangladesh. Given the competing arguments in the extant literature, the consequences of engaging in REMs is worthy of investigation.

Our study contributes to the literature in several ways. First, the issue of REMs in family firms is heavily under researched. Apart from the study by Achleintner et al. (2014) in a developed country context, most of the earnings management study of family firms address the accruals earnings management. Hence, our study contributes to the scant literature of REMs in family firms. The findings of our study suggest that family firms are found to engage in REMs more than the non-family firms in Bangladesh. This finding is in contrast to that of Achleintner et al. (2014) and the deviance of findings is perhaps due to the contextual difference of the two studies. Our findings provide evidence on REMs in family firms in a developing economy context. Hence, the findings of the study adds to the literature by providing the empirical evidence of REMs in family firms of an emerging economy and may be generalized in contexts similar to Bangladesh in terms of institutional weaknesses and inadequate investor protection.

Second, our study is the first to obtain empirical evidence of existence of curvilinear relationships between the level of different REMs and family ownership. The findings in our study suggest that the magnitude of REMs increases with the increase in the level of family ownership at earlier ownership threshold highlighting the entrenchment effect. At a relatively higher family ownership this pattern reverses, perhaps indicating stronger alignment effect.