Family Owned Firms and Earning Quality

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In this paper, we investigate the empirical evidence of family-owned firms for various aspects. The main objective of the study is to analyze the performance of family ownership of firms with respect to earnings quality. This study investigates whether the controlling family involvement in accrual-based earnings management manipulates the financial reports in Malaysia. This study has also catered to the conflict of agency theory and how it influences earnings management. The sample data consists of nonfinancial listed firms of Malaysia over the period of 2009-2015. The final data relies on information from the top 200 non-financial firms, listed in the stock exchange of Malaysia.

**Key words:** family firm, earnings quality, agency problem, earnings management.

**Introduction**

Family Owned Firms and Earnings Management is a major topic in the field of financial accounting, this is because family firms have a greater proportion in the business market throughout the world (Hashmi et al., 2018). For example, in India, about 68% of the firms are family owned, either through direct control or indirect control. In the United States of America, every third company is owned by families and they have around 11 percent of cash flow rights and 18 percent of voting rights. Prior studies opine that the performance and behavior of family-owned firms is better than that of firms from diverse ownership due to the unique characteristics of trust and commitment (Chi et al., 2015; Senam, Akpan, & Mboho, 2017; Nasir et al, 2018).

In Malaysia, companies run under corporate governance based on an equity structure which affects board composition, board practices & board decision making. There are different kinds of shareholders in Malaysian companies (Al-Matari 2014), and most of the companies’ equities are owned by either individuals or families (Kamardin 2014). Family-owned business provides
a competitive advantage for the new generation to enhance business structure in order to achieve the benefits that come from the knowledge of family members (De Massis & Kotlar, 2014; Ploenhad, Laoprawatchai, Thongrawd, & Jermsittiparsert, 2019). The internal knowledge of the family members combined with loyalty and trust helps business to run effectively and provides the opportunity to generate a competitive advantage. In diverse ownership firms, the board of directors is used to hire professional recruiters to make the succession decisions and the third party selects the successor on the basis of professional competencies. Whereas, in the family-owned businesses successors are selected from the family whether they have required competencies or not. This issue is very rare and usually happens only once in each generation.

It is often argued that the earnings quality of a family owned business is higher and that it is always an open issue to be managed. De Massis & Kotlar (2014) argue that family-owned firms tend to engage in earning management in order to secure the benefits of the family in the long term. However, it is not easy for the board to manipulate income in family-owned firms. Empirical studies identify that board independence causes less control in earning management (Leuz & Wysocki, 2016; Sethi & Ghatak, 2018; Hussain, Ali, Thaker & Ali, 2019). Earnings management occurs when managers try to manipulate the financial statements in order to get benefits or mislead the stakeholders about the performance of the organization. Earning management studies mainly focus on public listed companies, however, it is very rare to find a relationship between board independencies and earning management in family-owned firms, because they are sensitive to their reputation and give focus on the long term instead of short term strategies (Alfonso et al., 2015). However, family-owned business is prevalent around the globe (Carne et al., 2015). This is because; family-owned firms significantly play a critical role in the management of the company by selecting the members of the board (Madison et al, 2016).

Previous studies focused on earnings quality and earnings management in public listed companies, but little focus was given to family-owned firms or the agency problem between controlling and non-controlling shareholders when discussing lower earnings quality and earnings management (Stockmans, 2013).

**Literature Review**

Social scientists have openly discussed the causes that describe the presence of family-owned firms, most importantly in emerging economies. Economistd argue that the market of managerial talent and the market for corporate control cannot be run perfectly in the presence of family firms (Shahbaz et al., 2013; Villalonga 2018). If the managerial talent is not available in the market, for instance, firms may have to accept the successive member of the family that owns the firm as the managerial resource. Likewise, if there is no market for acquisition, then it is not easy to confidently threaten the management of badly performing companies with the
anticipation of acquisition, the management and ownership should be at the same point to attempt to eliminate agency conflict. The additional argument is that a family-owned firm is favorable in the situation where the enforcement cost, such as the unofficial contract used to facilitate the transaction or resource and output, is very high, and the threat of getting a penalty is very low. The faith among family members reduces agency conflict, and specifically, has been investigated by management scholars (Le Breton-Miller 2018; Fatula, 2018).

On the other hand, the imperfection of the market suggests that family-owned firms usually operate as a result of factors such as the high cost of contract enforceability and social capital linked with altruism and externalities. Mutual consciences among family members could lower the reserve price for key resources, which gives them the opportunity to outbid or undercut non-family firms in the external market (Eugster 2017; Sharafuddin, Sawad, & Wongwai, 2018). Likewise, a company can additionally progress with CSR (Jermsittiparsert, Siam, Issa, Ahmed, & Pahi, 2019). The company may not target the individuals for social work because it would be much less than the combined social responsibility of the firm. If the firm is owned by the family, ultimately it will benefit the family (Olkiewicz, 2018).

Family firms are usually a part of huge business groups (Singh et al., 2018), therefore "market imperfection" explains widely the view of the family firm. For instance, if the capital markets are imperfect, the investment funds of the firms are mainly derived from internal accruals. In such a situation, firms carrying wealthy internal accruals are in a viable position to initiate new business (Beaver et al., 2019), resulting in the development of business networks that overcome the problems associated with the imperfect capital market through internal accruals. It is also found that membership of large groups opens ways to easily access external capital funds. In many cases, the controlling family requires the top executive member of their family to closely look into the matters of the firm in such a way as to secure the future. This can also give rise to agency problems. (Daspit et al., 2016; Sanchez, 2018).

The literature explains that in family firms, managers are selected more on the basis of a personal relationship than in the search of the perfect candidate (Visintin et al., 2017). In many cases, managers belong to the members of the controlling family, or have some close personal relations with the family, in such cases relationships are more important than career progression. Managers are focused on the long term, not the increase profitability of the firm but the maintenance of the trust level of the shareholders. Previous literature proposed that the performance and the profitability of the firms depend on the relationship of the executive and family, the closer the relation, the lower the profit (Visintin et al., 2017). This sensitivity seems to be very low when the CEO of the company is the controlling shareholder (Jaggi et al., 2016). One more characteristic of a family owned firm is that the controlling shareholders desired to secure their investment in the long term. Founding families are a special kind of investor. The combination of undiversified family holdings, the requirement to pass the firm control to the
next generation, and interest over family reputation show that family shareholders are more concerned than other shareholders with respect to the survival of the firm in long term instead of profit maximization (Boling et al., 2016; Sharif, Wahab, & Sarip, 2017).

In an agency conflict, it seems to be unfavorable, as it gives rise to the non-optimization profit decision. Controlling families put all the effort in to save the leadership position through retaining control of the firm. Other shareholders are unable to contribute enough to get control of the firm. Therefore, the association with different potential financiers, for instance, banks and other financing companies, becomes critical (Kölling 2017). Although family-owned firms are very common in Asian economies (Subair, & Oriogu, 2016; Hashmi et al., 2018), usually the management structure is dominated by a family member in order to enhance the performance and maintain the control of the firm (Jaggi et al., 2016). This literature also covers two competing issues that influence earnings management in family-owned firms. These include the management entrenchment theory and agency theory. Management entrenchment exists in family firms as family members are personally involved in business operation and they are able to take over the business wealth that would harm the minority shareholders.

On the other hand, agency theory suggests that strong family ownership discourage earnings management and encourages earnings quality (Sadiq et al., 2019). Family members are strongly concerned about the family name, that’s why they avoid involving in earnings management and emphasize on earnings quality. Family firms discourage manipulation in financial reporting, as it hampers the family reputation and lowers the long term performance of the firm. Family members always trying to mould their own interests for the betterment of the firm (Siddiqui, & Anjum, 2013; Sadiq & Othman, 2017).

Considering management entrenchment theory and agency theory, Hashmi et al. (2018) document a positive association between family ownership and earnings management. Moreover, Cho et al. (2018) present evidence on the positive association between large shareholders and corporate performance in Korean firms. Similar evidence is also reported by Kim et al. (2016), who found a favorable impact of family ownership and control on firm efficiency and value. Several researchers have documented a relationship between family ownership concentration and earnings management in Asian economies (Chi et al., 2015; Cho et al., 2018). Chi et al. (2015) document a positive relationship between family ownership and earnings management in Taiwan, Haniffa and Cooke (2002) document a negative relationship between family representation on the board and voluntary disclosures in Malaysia. Therefore, we hypothesize that:

**H1. Family ownership is associated with better earnings quality.**
Methodology

Data

The sample data consists of non-financial listed firms of Malaysia during the period 2009-2015. The final data carries the information of top 200 non-financial firms, listed in the stock exchange of Malaysia. These firms belong to six non-financial business sectors, registered on the stock exchange of Malaysia likewise, Construction sector, Health care sector, Hotel sector, Properties sector, Utility sector and Plantation sector. This data does not include the information of financial institutions because it does not meet the criteria of empirical analysis.

Family Owned Firms

The empirical studies has recognized a number of ways in which families maintain control over firms.

- Firms can be controlled by the family without holding the majority of its share, if they raise its Capital by issuing dual-class share. Shares sold to the outside investor with no voting rights or significantly low voting rights (Agrawal & Nasser 2019). Degryse et al (2018) cite the case of Ericsson in which 40 percent of the voting right controlled by Wallenberg family, even though the contribution of the family is 1 percent of the whole capital of the firm. It is not the only usual phenomenon used by families to maintain their control over the firm. Therefore, dual-class share is very common and not difficult to issue in such countries like South Africa and Sweden (Kumar & Zattoni, 2017).

- The firm’s control can also be maintained by the pyramid. For instance, if company X owned an 80 percent share of company Y and a family owns 51 percent of company X, then approximately family owns 36 percent of company Y but still family carries the control of company Y. Usually in pyramid mechanism $t^1 2$ firm, and firm 1 controls firm 2 by having ownership proportion of $P_2$, the same way family controls firm 1 through proportion $P_1$, yet all $P$s are $0<P<1$. The family owns $\sum P$ proportion of $t^{th}$ firm's equity and control over the firm without having a significant proportion. Pyramids are generally utilized for maintenance of control, in East Asia as well as in Europe.

- Families can utilize cross-possessions to strengthen their command over gatherings of organizations. For instance, if Company Z and Company Z2 possess F percent of every other share, and if a family legitimately claims G percent of the offers of every one of these organizations, at that point the family will have compelling authority over both these organizations insofar as $(F + G)$ surpasses half of it (Azar et al., 2018). Crossholdings are generally utilized by Asian business families, apparently on the grounds that they diminish the straightforwardness of the possession structure of the organizations.
It is simple to realize that the cash flow rights and the control rights of the controlling family are different (for details, see Kumar & Zattoni 2017) and easily understandable with the above methods. Assume that a family controls the firm through a certain amount of percentage and that firms own another firm with some proportion, then doesn’t mean that the family owns the major shareholding but it may control both firms.

**Measurement of earnings quality**

Jones’ model of discretionary accruals will be used to identify earnings quality. Earnings quality may depend on the discretionary accruals. These performance models indicates the quality of earning by using the absolute value of discretionary accruals. The more the absolute value is the weak the earnings quality is and vice versa. Jones (1991) explains the discretionary accrual by using a framework in two steps: first, given the below model used to calculate the non-discretionary accruals and second, discretionary accruals which are the difference between total accruals and non-discretionary accruals. However, the total accruals are the difference between earnings without extra ordinary items and discontinued operation and net cash flow from operation,

$$\frac{TACC_fy}{TAS_{fy-1}} = \alpha_0 + \alpha_1 \frac{1}{TAS_{fy}} + \alpha_2 \frac{DREV_{fy}}{TAS_{fy-1}} + \alpha_3 \frac{PPE_{fy}}{TAS_{fy-1}} + \epsilon_{fy}$$

Where; TACC are the total accruals for firm f at year y, when total accruals (TACC) are defined as the change in non-cash current assets minus the change in current liabilities excluding the current portion of long term debt, minus depreciation and amortization, scaled by lagged total assets; TAS_{fy-1} are total assets for firm f at year y-1; DREV is the change in revenue for firm f at year y; and GPPE is the gross property plant and equipment for firm f at year y; and e is the predicted value of Jones Model.

**Estimation model**

While examining the influence of family ownership on earnings management, there are other variables that can also play a supporting role in earnings management e.g. Firm size, profitability and operational cash flow (Hashmi et al., 2018). We use these variables to extract the other factors that can also influence earnings management. The variable firm size can be calculated by total asset. Firm profitability based on a firm’s profitability ratios and the cash flows from operations are those net cash flows generated from operations after deducting cost and operating expenses. To further analyze the influence of family ownership in earnings management, the below model is used to investigate,
Discretionary accruals = f (family own; firm size, firm profitability; cash flow from operations).

To calculate the discretionary accruals we have to develop the regression model by using sample firm data.

\[ \text{ADJM} = a_1 + a_2 \text{FOW} + a_3 \text{FRSZ} + a_4 \text{FRPF} + a_5 \text{CFFO} \]

Where; ADJM is the discretionary accrual calculated by Jones Model; FOW represents the continuous variable of family owned firms; FRSZ represents the log size of firm size, which is calculated by log of total assets of firm \( f \) at year \( y \); FRPF represents the return on assets, which represents the firm performance of firm \( f \) at year \( y \); and CFFO represents the net cash flow from operating activities of firm \( f \) at year \( y \).

**Result**

**Descriptive Analysis**

The descriptive analysis of dependent, independent and control variables is given in below table. The mean value of discretionary accruals is approximately 0.43. This shows that around 43% of the accruals are discretionary. This research is based on previous studies in which discretionary accrual should be greater than 0.10 (Sadiq et al., 2019) and the standard deviation of discretionary accruals is higher than 0.30.

The descriptive analysis in the below table explains that, around 13% of the board occupied by family directors. However, the minimum and maximum value shows that the controlling power of the family firm varies from zero to 72%. These results are consistent with the findings of previous studies in the developing countries, where a large number of family owned firms exist (Hashmi et al., 2018). According to the sample data, they are very small in size as compare to the firms listed in the developed countries. Moreover, the average return on asset of listed firms is approximately 6.3%. The mean value of firm size i.e. log of total assets equals to 26.12. The cash flows from operations compared to total assets are negative.

<table>
<thead>
<tr>
<th>Variables</th>
<th>Mean</th>
<th>SD</th>
<th>Minimum</th>
<th>Maximum</th>
<th>Skewness</th>
<th>Kurtosis</th>
</tr>
</thead>
<tbody>
<tr>
<td>ADJM</td>
<td>0.431</td>
<td>0.323</td>
<td>-0.11</td>
<td>7.641</td>
<td>15.505</td>
<td>300.464</td>
</tr>
<tr>
<td>FOW</td>
<td>0.132</td>
<td>0.186</td>
<td>0</td>
<td>0.723</td>
<td>1.216</td>
<td>3.264</td>
</tr>
<tr>
<td>FRSZ</td>
<td>26.123</td>
<td>1.323</td>
<td>16.123</td>
<td>28.143</td>
<td>-0.713</td>
<td>2.634</td>
</tr>
<tr>
<td>FRPF</td>
<td>0.063</td>
<td>0.142</td>
<td>-0.798</td>
<td>2.364</td>
<td>7.001</td>
<td>2.643</td>
</tr>
<tr>
<td>CFFO</td>
<td>-0.063</td>
<td>6.642</td>
<td>-101.924</td>
<td>88.215</td>
<td>-6.711</td>
<td>236.758</td>
</tr>
</tbody>
</table>

**Regression result**

65
The regression results show the relationship of family own firms with earnings management in below table. This table is based on Jones model of discretionary accruals, in which the R value are significantly higher as compare to those reported in the previous studies (Sadiq et al., 2019; Sadiq & Othman, 2017). The R value also explains that this model is enough capable to provide the effects of family ownership on earnings management.

<table>
<thead>
<tr>
<th>Variables</th>
<th>Z Value</th>
<th>P Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>FOW</td>
<td>-0.0911**</td>
<td>0.019</td>
</tr>
<tr>
<td>FRSZ</td>
<td>-0.0828***</td>
<td>0.000</td>
</tr>
<tr>
<td>FRPF</td>
<td>0.0291</td>
<td>0.391</td>
</tr>
<tr>
<td>CFFO</td>
<td>0.0002</td>
<td>0.712</td>
</tr>
<tr>
<td>R^2</td>
<td>0.285</td>
<td></td>
</tr>
<tr>
<td>N</td>
<td>1375</td>
<td></td>
</tr>
</tbody>
</table>

Note: ***, ** and * indicate statistical significance at the 1%, 5% and 10% levels, respectively.

Regression results indicate that the relationship between discretionary accruals and family ownership (FOW) is significant and as well as negative. In line with the findings of Hashmi et al. (2018), this study found that family owned firms are less involved in accrual-based earnings management activities, and reporting better earnings quality. Since, families have the controlling authority of the firm, they are liable to keep the reputation of the family name. In this manner they discourage fabrication in reporting the financial statement. Firm’s size (FRSZ) exemplified negative and significant relationship with accrual earnings management activities, which indicates that large firms are less involved in earnings management and reporting high earnings quality. This is consistent with the findings of Sadiq et al. (2019), who suggest that large firms are reporting better earnings quality because most of the large firms are audited by the big four auditors. Therefore, they are less likely to become engaged in earnings management activities. With respect to regression results, a firm’s profitability (FRPF) and cash flow from operating activities (CFFO) are positive but not significantly related to earnings management activities.

**Conclusion**

The literature about corporate governance is progressively focusing on earnings quality of family own firms, and in normal circumstances, agency theory has gained importance. This is because they are part of a large business group, particularly in developing economies. In this study, many issues were identified; why family firms easily survive in the business market,
why small firms always want to be a part of a big business group, the benefits of family owned firms, the systems utilized by families to control firms, the results of issuing shares on voting rights and cash flow management, private control benefits and earnings management, and the (non-linear) connection between family control and the transparency in financial reporting. The research has provided detailed evidence regarding these issues as referenced throughout this article. Yet, most of the references come from the institutional research of a number of developed countries such as China, Germany, India, South East Asian countries, South Korea and the United States. Unfortunately, Latin American countries have never participated in this field of study. Comparison of different countries in the field of corporate governance and financial institution is a clear necessity. The agency conflicts are also one of the main issues in family firms and thus there is an identified need for further research on the conflict of corporate governance and earnings management in family owned firms.
REFERENCES


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