

# Family Control, Socioemotional Wealth and Earnings Management in Publicly Traded Firms

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**Abstract** We examine the unique nature of agency problems within publicly traded family firms by investigating the earnings management decision of dominant family owners relative to non-family. To do so, we draw upon literature demonstrating that family owners are loss averse with respect to the family's socioemotional wealth, or the affective endowment derived from firm ownership and control. Our theory and findings suggest that potential reputational consequences of earnings management lead family principals to engage in less of this practice relative to non-family firms, and that founder family firms are less likely than non-founder family firms to use earnings management. Moreover, the family-firm effect varies with the firm size, the degree of CEO entrenchment, and the firm's stock structure. We provide important insights regarding differences between family and non-family principals in the use of unethical accounting practices, thereby extending agency theory and advancing an underdeveloped research area.

**Keywords** Accounting ethics · Earnings management · Family firm · Socioemotional wealth · Agency · Governance

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Earnings management occurs when “managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers” (Healy and Wahlen 1999, p. 368). Philosophical references to ethical behavior are commonly associated with what is considered to be “fair,” “right,” and “just” (Hosmer 1995, p. 394; Steiner 1972). It is clear that misleading uninformed stakeholders via aggressive use of earnings management falls short of the “right” and “just” standard. That is, higher levels of earnings management are likely to be considered unethical (Elias 2002; Kaplan 2001), or at the very least, questionable from a moral hazard perspective. In fact, earnings management is a perfect example of an (unethical) action that involves a moral judgment, as it falls in the “gray area between legitimacy and outright fraud” (Elias 2002, p. 33). An impressive volume of research examines how executives use earnings management as an accounting tool to paint a rosier picture of the firm's financial condition (e.g., Dechow et al. 1996; Harris and Bromiley 2007; Zhang et al. 2008). However, the role of the dominant shareholder in the earnings management decision has received sparse attention in this literature. As a result, we know little about how this form of unethical behavior differs across ownership—firm principal—categories. We address this gap by analyzing how earnings management practices vary as a function of principals' preferences. To this end, we compare the prevalence of unethical accounting behavior in the form of earnings management between publicly traded firms where a family is the dominant principal and firms without a major family influence.

Building on prior research by Gomez-Mejia et al. (2007, 2010, 2011, 2014), we argue that the family's desire to

protect its socioemotional wealth (i.e., the stock of affect related value that the family has endowed in the firm) should induce dominant family principals to discourage executives from using earnings management practices that most people would consider questionable on ethical grounds. Our theory and empirical results make various important contributions to the ethics, corporate governance, and family business literatures. First, we advance knowledge regarding ethical decision making within family firms. While advancements have been made in the family business literature regarding preferences for good corporate citizenship and corporate social responsibility (Berrone et al. 2010; Dyer and Whetten 2006), knowledge regarding how family firms deal with moral hazard issues is rather limited (Gomez-Mejia et al. 2011). Our arguments and findings suggest that the potential negative consequences of unethical practices in the form of earnings management for the family principals' image and reputation encourage them to resist succumbing to moral hazard, in contrast to non-family owners, who have comparably less at stake.

Second, by using the concept of socioemotional wealth to explore ethical behavior of family firms, we add to a growing stream of research corroborating the predictive value of socioemotional wealth in explaining major organizational decisions that distinguish family from non-family-controlled firms. As such, we extend the prior literature that has used socioemotional wealth as a construct to explain differences between family and non-family firms on a variety of strategic choices, such as risk taking (Gomez-Mejia et al. 2007), diversification (Gomez-Mejia et al. 2010), pollution control (Berrone et al. 2010), and research and development (R&D) investments (Chrisman and Patel 2012).

Third, we shed new light on the unique nature of agency problems associated with earnings management behavior as a function of family control. From a normative perspective, we argue that family control is likely to result in lower earnings management, and thus, lead to improved financial reporting transparency. Earnings management may impose agency costs upon those not directly involved in the firm's accounting decisions, as it both deceives others regarding the financial state and earnings volatility of the focal firm and distorts the multiple incentive alignment systems that are based upon accounting earnings. Given that distorted (or misreported) earnings pervert incentive alignment systems and potentially alters investment decisions—which may prove costly for various firm stakeholders—and family ownership is associated with a lower incidence of this practice, the influence of the family principal leads to lower agency costs associated with the misreporting of earnings. However, the marked difference in tolerance for earnings management between family and

non-family principals suggests that the presence of dominant family principals may lead to a different type of agency problem, in the form of principal–principal conflict.

Finally, we build upon discourse examining how the socioemotional wealth effect may differ *within* family firms. Various authors have cautioned against treating family firms in simplistic terms as a monolithic entity, while ignoring the heterogeneity of these organizations (e.g., Chrisman and Patel 2012; Miller et al. 2010). We theorize that four such distinguishing factors are: (1) family firm stage, represented by the continuing involvement of the founder, (2) firm size, (3) CEO tenure, and (4) dual-class stock structure. We argue that socioemotional endowments of family owners are diluted as the firm grows and as later generations of the family become involved with the firm. This suggests changes in family firm behaviors over the life cycle of the firm, with the family owners less likely to make ethical decisions. We further argue that CEO tenure is indicative of the extent of mutual obligation between the CEO and the greater family, and the adoption of a dual-class stock structure is indicative of the extent of the family's concern for reputation. We find evidence in support for these arguments, adding nuance to our understanding and treatment of family firms.

## Theory and Hypotheses

### The Ethics of Earnings Management and Agency Problems

Earnings management has been extensively studied in the finance and accounting literature, and is defined as the use of “judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers” (Healy and Wahlen 1999, p. 368). Much of this research has focused on the benefits that CEOs gain from earnings management. For instance, Healy (1985) empirically demonstrated that managers adjust discretionary accruals to report a higher level of earnings to maximize the value of their performance bonus. Along similar lines, CEOs have been found to adopt earnings management practices to inflate the value of their equity based pay (Bergstresser and Philippon 2006; Burns and Kedia 2006), and to reduce their employment risk (Cheng and Warfield 2005). CEOs of firms that are targets of hostile takeovers are likely to manage earnings in an attempt to inflate the stock price, and thus, dissuade the potential hostile acquiring firm from proceeding with the acquisition (Easterwood 1997; Erickson and Wang 1999). Likewise, when earnings are poor, CEOs have been found

to engage in earnings management to conceal the true financial position of the firm from outsiders and reduce the risk of termination (Leuz et al. 2003; Haw et al. 2004).

Ethical behavior is typically associated with references to what is considered “fair,” “right,” and “just” according to social norms (Hosmer 1995, p. 394). Earnings management definitions typically include references to “misleading” and “deceiving” of stakeholders not privy to the use of discretion in the accounting process to inflate reported earnings.<sup>1</sup> In a study of perceptions of the ethics of earnings management, Elias (2002) found that higher levels of earnings management are likely to be perceived as unethical by certified practicing accountants. Said differently, higher levels of earnings management increase the possibility that the behavior of those influencing earnings management practices will be perceived as unethical. Hence, in the parlance of agency theorists, aggressive use of earnings management represents a moral hazard whereby information asymmetries may induce top managers and/or dominant principals to deceive others about the firm’s financial health (Zhang et al. 2008).

Despite a large volume of previous research examining earnings management, little is known about the role of dominant shareholders in this process, and in particular the influence of family owners, who represent the most prevalent type of principal around the world (LaPorta et al. 1999). In a review of this literature, Salvato and Moores (2010, p. 236) conclude that “accounting fails to receive attention as a phenomenon that merits distinct consideration in family firms.” This research gap is consequential given the significance of accounting earnings to strategic management and allied discipline scholars, and to firm stakeholders more broadly. Addressing this gap, we draw upon the concept of family firm loss aversion with regard to socioemotional wealth to argue that firms with dominant family principals will be less likely to allow the CEO to engage in unethical behavior in the form of earnings management. We develop this argument in detail below.

### Family Firms and Socioemotional Wealth

Socioemotional wealth has been used by various scholars to analyze and predict behaviors of firms where families exercise substantial control (customarily referred to as “family firms”). Gomez-Mejia et al. (2007) described “socioemotional wealth” (SEW) as an overarching construct that captures a host of “affective endowments” derived by dominant family principals as part of their

ownership position in the firm. For example, various facets normally associated with socioemotional wealth have been used to study how the family derives a sense of self and identity from the firm (Kepner 1983), receiving recognition for generous actions (Schulze et al. 2003), enjoying personal prestige in the community and having social support among friends and acquaintances (Lee and Rogoff 1996; Stafford et al. 1999; Taguiri and Davis 1996), maintenance of group integrity (Habbershon and Pistrui 2002), accumulation of social capital (Arregle et al. 2007), a sense of pride in family roots and dynasty (Berrone et al. 2012), and satisfaction from appealing to the needs of multiple stakeholders (Cennamo et al. 2012). Underlying these socioemotional wealth aspects is the family owner’s desire to project and perpetuate a positive family image and reputation (see review by Gomez-Mejia et al. 2011).

One recurrent theme in this literature is that, for the family, the pursuit of financial wealth may take a back seat to socioemotional wealth preservation. For instance, psychiatrist Kets de Vries (1993) studied 300 firms using in-depth interviews with family owners, and found that they placed a high priority on the satisfaction of the family’s affective needs through the business, often at the expense of financial objectives. He reports that a key non-financial objective is projecting a positive public view of the family’s name that extends into future generations. Using the behavioral agency model, Gomez-Mejia et al. (2007) provided support for Kets de Vries (1993) in a comparative study of family-controlled and non-family-controlled Spanish olive oil mills. The family-controlled mills were three times more likely to opt out of joining a cooperative as those non-family-controlled, despite it being a financially lucrative option. Joining a cooperative was associated with the loss of the family’s socioemotional wealth, including the loss of family image in the community, the loss of opportunity for perpetuation of the family’s name, and the loss of self-identity tied to the family and the business as an extension of the family. Likewise, Berrone et al. (2010) used the behavioral agency model to show that family firms in the chemical industry polluted less because of a desire to prevent socioemotional wealth losses, and thus, invested more than non-family firms in costly pollution control and prevention equipment in order to avoid diminished status and defacement of the family’s image.

Reputation has long been established to be an important consideration to all firm stakeholders, such as the firm’s management team, regardless of family ownership (Deephouse and Jaskiewicz 2013; Fombrun and Shanley 1990; Hitt et al. 2001). This is because of the numerous benefits reputation can provide, such as signaling product quality and enhancing access to capital markets (Beatty and Ritter 1986). While sustaining a positive image may be desirable to all stakeholders associated with any firm, the damaging

<sup>1</sup> A higher level of earnings management (that is, more aggressive) is, therefore, the use of judgment in financial reporting (such as the use of accruals) to inflate reported profits (or reduce losses) in the extreme.

impact of earnings management on reputation is likely to be more severe to family owners and managers. First, there is little doubt that the firm becomes an integral and inescapable part of the lives of family owners, whereby “the face of the firm is the face of the family” (Berrone et al. 2010, p. 84). Given that family shareholders identify more strongly with the firm, firm reputation becomes more of a concern to family shareholders relative to non-family shareholders (Deephhouse and Jaskiewicz 2013). By contrast, non-family shareholders and professional managers are more likely to view their relationship with the firm as more distant, transitory, and utilitarian (Lubatkin et al. 2005). That is, owners and managers’ identification with the organization is much stronger for family than non-family firms, and thus, a tarnished firm image is a bigger hazard for the family (Berrone et al. 2012; Deephhouse and Jaskiewicz 2013). Second, earnings management may take some time to be exposed, if it is at all, and because the family is tied to the firm for the long haul, it should be more concerned with eventual revelations of such practices. Last, earnings management generally involves a gamble, so there is uncertainty about whether or not the firm will be caught. Executives of non-family firms may be more tempted to take a calculated risk to engage in earnings management (hoping not to get caught) and receive the benefits from it (i.e., the appearance that the firm is better off financially than it actually is), because they have the option to go elsewhere. And given that short-term investors may benefit from earnings management in the firms that they hold stocks—for instance, those with a diversified portfolio that sell and buy stocks on a frequent basis—they (or their representatives on the board) are unlikely to monitor these practices very closely.

Following the arguments above, family owners should place a relatively greater value on avoiding image or reputational problems associated with unethical behavior as reflected in earnings management or earnings manipulation. We suggest that family owners will weigh the potential loss of socioemotional wealth associated with earnings management against any potential benefits. In the following section, we further elaborate on this theoretical mechanism by analyzing the role of dominant family shareholders in the earnings management decision.

### The Influence of Dominant Family Owners

Decisions regarding earnings management are likely to be influenced by dominant family principals for two related reasons. First, family principals exercise indirect and direct control over the board. Stock ownership typically translates into board representation; thus, family owners are likely to be members of the board of directors. Agency theory suggests that board members play an important advice and

monitoring role in firm decision making (Beatty and Zajac 1994; Fama and Jensen 1983). The strategic and oversight responsibilities of firm directors are increasingly demanded by minority shareholders and other firm stakeholders (Allio 2004; Carpenter and Westphal 2001). More often than not, ownership by the family means that the board will include representatives of the founding family (Schulze et al. 2003), who therefore, will have significant influence in discouraging earnings management.

Second, the aforementioned monitoring within family firms is more likely to lead to greater scrutiny of CEO behavior by family principals, who may analyze major decisions and financial statements more directly. More intense monitoring is likely to result in the CEO acting in accordance with dominant shareholder preferences,<sup>2</sup> as opposed to pursuing a self-serving path to maximize their compensation or reduce employment risk (Demsetz and Lehn 1985). Closer monitoring by the board and the family implies that key accounting decisions, such as those regarding the possibility of earnings management, are also likely to be more closely monitored and influenced by family owners.

### Ethical Behavior, Firm Reputation, and Socioemotional Wealth

Firms may engage in earnings management as a gamble, hoping to obtain financial benefits from this practice, while at the same time avoiding detection. The practice of earnings management can provide substantial financial benefits to the firm, albeit at the cost of deceiving stakeholders and risking the possibility of this being detected and unethical behavior revealed, which may harm the firm’s reputation (Becker et al. 1998). On the positive side, firms have been found to manage earnings more during periods prior to stock issues to attract investors and improve demand for the stock (Dechow et al. 1996; Teoh et al. 1998; Rangan 1998). When earnings are poor, firms have been found to engage in earnings management to conceal the true financial position of the firm from outsiders and minimize declines in the stock price (Leuz et al. 2003; Haw et al. 2004).

On the other hand, as noted above, despite its potential benefits, earnings management has negative implications for the firm if this practice is subsequently unmasked. Besides possible government imposed fines, earnings management has been linked to negative reputation or poor credibility (e.g., Becker et al. 1998), and a perception that those influencing the decision have behaved unethically

<sup>2</sup> Extant literature generally defines a dominant shareholder as one with at least 5 % of outstanding stock. Our definition of a family firm is consistent with this ownership threshold.



(Elias 2002). The record of deception associated with unethical behavior often leads to an erosion of the customer base (Roychowdhury 2006). Negative publicity due to deceptive acts of a firm—of which earnings management is an example—has been negatively associated with reputation (Fombrun and Shanley 1990). In sum, earnings management represents a gamble—it can provide short-term financial benefits, but it can also be highly detrimental to the firm in the long run due to the reputational consequences.

The key to understanding the collateral damage of earnings management due to reputation decline—and hence sensitivity to the downside of taking the gamble of unethical behavior—is the degree of owner bond or emotional attachment to the firm, given this will dictate a firm's exposure to both the short-term and long-term implications. Reputation decline has been shown to negatively impact both immediate firm performance and the sustainability of superior performance, or longer-term firm performance (Roberts and Dowling, 2002). If owners feel less bound to the firm, they will be able to sell their share of the firm and avoid exposure to those longer-term financial consequences. For instance, if earnings management is uncovered and firm reputation is threatened, non-family shareholders—the largest group being transitory institutional investors (Useem 1996)—may choose to sell off their share of the firm's stock to avoid the long-term performance consequences. An average mutual fund, for example, has a 95 % portfolio turnover per year (Cremers and Petajisto, 2009), meaning that in a single year an average fund will sell off almost all of its holdings and replace them with different stock.<sup>3</sup> This underscores that many investors have a very transitory and utilitarian (i.e., low bond) relationship with the firm, meaning that they will be likely to sell their shares if they anticipate further losses. However, selling a stake in the firm is far more difficult for dominant family principals, whose identity and fortune are closely meshed with that of the firm (Berrone et al. 2010). Liquidating the family's stake in the firm would essentially extinguish their socioemotional wealth. As such, because of their socioemotional bond to the firm, family principals differ from non-family owners in that they are likely to incur not only short-term, but also the long-term financial losses if earnings management is discovered, as they must “weather the storm.”

In addition to the financial consequences, family owners are also subject to a unique direct socioemotional effect due to the stigma of earnings management that non-

family owners are not. Dominant family owners seldom enjoy anonymity, and they tend to be inextricably tied to the firm in the long run—the reputation of the family is reflected in that of the firm and vice versa (Reiss 1981). Because of its unethical connotations, negative publicity associated with earnings management could lead to significant reputation, and hence immediate socioemotional wealth losses for family members, because it tarnishes the family's name (Adams et al. 2004; Dyer and Whetten 2006). Thus, despite any short-term financial benefit that family owners may derive from taking this gamble, the long-term socioemotional downside of earnings management looms as a significant potential loss at a very deep and personal level. It follows that family firm principals will give stronger consideration—relative to non-family principals—to the potential for long-term reputation loss that may result from taking the earnings management gamble.

In sum, family principals—in the dominant shareholder role—are in a unique “dual threat” position when contemplating an earnings management gamble. On the downside of the gamble, if earnings management is uncovered, they are likely to suffer larger financial losses (relative to non-family firms) due to their wealth concentration and long-term attachment to the firm, as well as unique socioemotional wealth losses resulting from damage to family image. Greater severity of negative consequences, without any offsetting greater benefits, makes it less likely that dominant family principals will choose the gamble of engaging in earnings management relative to non-family principals. Thus:

**Hypothesis 1** Earnings management will be lower in family-controlled firms relative to non-family-controlled firms.

#### Founder Firms and Earnings Management

Founder firms are owned and managed by an entrepreneurial founder or founder family (Le Breton-Miller and Miller 2008). If the firm is successful enough to survive until the founder passes the firm to subsequent generations, new family members will assume ownership and potentially management positions within the family firm. Research investigating the effect of inter-generational change—or life-cycle effects—in family firms has focused on two ideas. First, it has been argued that founders are more strongly driven to preserve socioemotional wealth, given that they have toiled to launch and develop the firm; thus, the emotional attachment and identification with the firm is said to be stronger in founders than subsequent generations of family owners, later in the family firm life cycle (Gomez-Mejia et al. 2001, 2007; Schulze et al. 2003;

<sup>3</sup> Larger investors may sell down their holdings over periods of time in order to avoid the negative price effects of selling large blocks of shares (Griffin et al. 2003).

Stockmans et al. 2010).<sup>4</sup> One could extend this to argue that family socioemotional wealth is likely to be diluted as the life cycle of the firm evolves and later generations become involved, reducing the socioemotional effect. For instance, as later generations are forced to share influence over the organization with other family members, they are likely to exhibit lower levels of psychological ownership and more likely to pursue self-interested motives rather than aiming to enhance the welfare of the entire organization (Wasserman 2006). The evolution of the firm to an entity controlled by many descendants of the founder as opposed to a single founder (or few founders) is also likely to entail greater reliance on bureaucratic controls (Williamson 1967), which can change the culture or “character” of the firm, leading to further separation of the organizational–family identity, and thus, dilution of family socioemotional wealth.

Second, a perspective deriving from the entrepreneurship literature is that founders may be more driven by the necessity of growth and innovation in the early stages of a firm’s life (Le Breton-Miller and Miller 2008). We offer a reconciliation of these two perspectives in the context of earnings management. We advanced an argument earlier that family owners are concerned about two related problems associated with the use of earnings management: long-term financial losses and socioemotional losses, both resulting from a blow to firm reputation. We argue below that founders are similarly threatened on two different but related fronts.

First, socioemotional wealth is argued to be most salient at the founder stage of the firm. Because of its prominence, founder owners will place paramount importance on socioemotional wealth preservation, even more so than later generations of family owners. As such, given the unethical connotations to earnings management, they should be most driven to avoid the reputational fallout and socioemotional wealth losses that follow the discovery of these accounting practices. Moreover, founders are driven by growth, and stellar firm reputation is crucial for obtaining the most desirable financing terms and building relationships with the firm’s stakeholders, including its suppliers, creditors, and strategic partners (e.g., alliance partners). Damaged firm reputation as a result of earnings management practices can prove disastrous for the founder’s growth goals, because they may be seen as unethical and no longer

<sup>4</sup> Stockmans et al. (2010), using a sample of Flemish firms, find that earlier generations of the family firm will be more likely to use earnings management. They argue that earlier generations are more strongly motivated to preserve SEW, yet suggest that this leads to more earnings management. We contrast this approach by arguing that the reputational effect of earnings management upon socioemotional wealth leads to the opposite prediction: less earnings management by founders (i.e., earlier generations).

trustworthy by investors, financial institutions, customers, and suppliers. While negative reputation can financially hurt all firms, this effect is more distal compared to the way negative reputation damages key relationships and impedes the founder’s “build” strategy (Le Breton-Miller and Miller 2008). Thus, the negative reputational consequences of earnings management are likely to be more prescient for founder family owners relative to later generations.

In sum, given greater socioemotional wealth endowment that is subject to loss and stronger growth-orientation at the founder stage than in later generations, founders are even more likely to avoid earnings management relative to later generations of family principals. Formally:

**Hypothesis 2** Founder family firms are less likely than non-founder family firms to use earnings management.

## Contextual Influences

### Firm Size, Identity, and Earnings Management

According to social identity theory (Tajfel and Turner 1986), part of an individual’s self-concept—the way an individual “defines” him or herself—is derived from membership with a certain social group or entity (Tajfel 1981). Each individual can have multiple identities; for example, people identify with their gender (e.g., female), nationality (e.g., American), or even regional background (e.g., the South, or the East Coast). An important type is organizational identity, defined as “the perception of oneness with or belongingness to” an organization (Ashforth and Mael 1989, p. 21). Organizational identity should be particularly salient to the socioemotional wealth endowment in family firms, where the principal’s identity (i.e., family identification) and identity with the company (i.e., organizational identification) become closely tied together (Berrone et al. 2012). As a result of the process of identity formation in family firms, family identity (that is, individual identification with the family as a social group) and firm identity (the individual identification with the family firm as a social entity) often become inseparable, with “the face of the firm mirroring the face of the family” (Stockmans et al. 2010). Due to strong organizational identity, reputational losses to the firm as a result of earnings management could hurt family members at a deep personal level, as their view of themselves is psychologically intertwined with the fate of the organization (Ashforth and Mael 1989).

The arguments above are more likely to hold when the firm is smaller, as this usually implies greater psychological ownership of the enterprise given that the family tends to be heavily involved in the firm’s affairs (Gomez-Mejia

et al. 2011). As the firm grows larger, however, the family must usually obtain additional financing by issuing stock or obtaining debt financing, thereby ceding some of the family control (Mishra and McConaughy 1999; Schulze et al. 2003). This loss of control implies dilution of socioemotional wealth as the family is forced to share influence with outsiders (Wasserman 2006), and the character of the firm changes due to the implementation of greater bureaucracy to control the larger entity (Williamson 1967). Moreover, as the firm grows larger, the family may not be able to fill required managerial needs from within the family's talent pool, and may be forced to reach for outside managerial talent (Lubatkin et al. 2005). Relinquishing power to professional managers, who do not identify with the family and are, thus, less likely to develop similarly strong organizational identity, further reduces the socioemotional wealth preservation motive.

In sum, similar to the life-cycle effect described earlier as firms evolve to post-founder stages, as the firm evolves into a much larger entity, family and organizational identity become less isomorphic and socioemotional wealth is likely to be diluted. Thus, the negative effect of family loss aversion with regard to socioemotional wealth on earnings management will grow weaker as firm size increases. Formally:

**Hypothesis 3** The negative effect of family ownership on earnings management weakens as the size of the firm increases.

#### CEO Entrenchment

Entrenched CEOs are those who are more secure in their roles, and therefore perceive a lower risk of dismissal. CEO entrenchment is often associated with long tenure in the role and strong relationships with the board of directors (Finkelstein and D'Aveni 1994). In the case of family firms, entrenched CEOs have been entrusted with the responsibility of preserving the family firm's stock of socioemotional wealth; those CEOs who do not pursue the family's objectives are likely to be removed from this privileged position (Gomez-Mejia et al. 2003). Trust and respect bestowed upon the CEO by the family owners is likely to lead to a perceived need for mutual obligation by the CEO. This is based on a theory of social exchange, suggesting that the provision of favor from one party to another leads to mutual obligation (Cropanzano and Mitchell 2005). Extant research in this area concludes that both parties tend to benefit from reciprocal social exchange relationships (see Cropanzano and Mitchell 2005, for a review). Applying this to the context of the family firm, an entrenched CEO within a family firm is likely to feel obliged to pursue the family owners' socioemotional

objectives in return for the privilege associated with the trust of the family.

A contrasting perspective to the above view is the view that CEO entrenchment leads to greater autonomy and power, and therefore a greater probability that the CEO opportunistically pursues his/her own objectives, independently of the owners (Finkelstein and D'Aveni 1994). However, we suggest that the greater intensity of monitoring within family firms (Gomez-Mejia et al. 2003) is likely to mean that entrenched family firm CEOs are less likely to be able to pursue firm policy that is not aligned with the family's non-economic objectives. That is, we suggest that the former effect—that mutual obligation is likely to lead to greater adherence to the goals of dominant shareholders—is more likely to apply in the context of family firms. The logic regarding entrenched CEOs and their commitment to family objectives is likely to apply equally to family and non-family CEOs. An agency problem is argued to exist in family firms given family members typically have different objectives, meaning that those with significant influence—such as the CEO—will opportunistically pursue their private agenda (Schulze et al. 2001). The difficulty of observing CEO behaviors allows the CEO some flexibility in pursuing these goals (Gomez-Mejia et al. 2001). Yet, like the non-family CEO, the granting of trust by the remainder of the family—as reflected by the CEO's entrenched position within the firm—creates an inducement for the CEO to act in the best interest of the family.<sup>5</sup> This perceived CEO obligation is likely to extend to preserving the reputation of the family through minimizing the use of earnings management. Therefore:

**Hypothesis 4** The negative effect of family ownership on earnings management is accentuated (reinforced) as the CEO becomes more entrenched in their role.

#### Control and Family Reputation

A family objective that appears to compete with the goal of reputation preservation has been the appropriation of wealth from non-family shareholders. As noted above, family firms have been argued to expropriate from non-family shareholders (Fan and Wong 2002). This principal-principal conflict has also been highlighted by research examining the use of dual-class shareholdings by founding family owners, which demonstrates that multiple classes of stock allow the family to create a wedge between shareholding (and associated cash-flows) and firm control (Villalonga and Amit 2009). Dual-class structures involve a

<sup>5</sup> This is consistent with March and Simon (1958) argument that inducements within organizations lead to greater contributions by those employees receiving the inducement.

special class of stock with differential voting rights, held in the hands of founders or founding family owners, in addition to regularly traded firm stock. Typically, the “inferior” publicly traded stock carries one vote per share, while the “superior” stock carries ten votes per share (Gompers et al. 2010).

This use of dual-class shareholdings to maintain family control has been shown to reduce firm value, hence creating agency costs for non-family shareholders (La Porta et al. 2002). While control is positively related to family socioemotional wealth, it is likely to be achieved at the expense of reputation or conflict with non-family stakeholders, thus negatively impacting socioemotional wealth through this second-order effect. While these apparently competing socioemotional objectives are well documented in the family firm literature, little is known about when a family firm is likely to perceive greater socioemotional value in reputation versus control.

Family firms that have adopted dual-class shareholding structures are likely to have made a decision to subordinate reputational objectives to other firm objectives. That is, they have signaled that they place less value on the reputation damage and associated loss of socioemotional wealth that is likely to result from the implementation of a controlling mechanism that is considered inequitable by non-family shareholders (Villalonga and Amit 2006). Given that definitions of ethical behavior converge around what is perceived as fair and just (Hosmer 1995, p. 394; Steiner 1972), the inequity of dual-class stock would appear to fall within the definition of unethical conduct. Said differently, the family firm with dual classes of stock appears to be less sensitive to reputation loss associated with unethical behavior. We conclude that the use of dual classes of stock is likely to attenuate the likelihood that family firms will engage in less earnings management to preserve their reputation. Thus:

**Hypothesis 5** The negative effect of family ownership on earnings management is weaker where the family firm has adopted a dual-class stock structure.

## Methods

### Sample and Data

Data used to flag firms as family or non-family was taken from the highly cited and influential study by Anderson and Reeb (2004), which utilized S&P 500 firms in the United States over the period from 1992 to 1999 (the sample excludes banks and public utilities because of high levels of regulation in those industries). The advantage of using this classification is that it has been validated by prior

research. Moreover, our sample time-frame precedes the passage of the Sarbanes–Oxley Act, which may have obscured the effects of family vs. non-family ownership due to the confounding influence of a new regulatory regime. We extracted firm-level data from Compustat. Data on dual-class firms were obtained from the dataset summarized and reported in Gompers, Ishii, and Metrick (2010), which includes data on all publicly traded dual-class firms in the United States. Data on CEO compensation and tenure were obtained from Compustat’s Execucomp database. To determine if the CEO of each firm in our sample was the founder in each data year, we inspected the individual firm’s Web site as well as the investor Web site ([www.fundinguniverse.com](http://www.fundinguniverse.com)). The final sample includes 1,149 firm–year observations; 441 of these were for family firms.

### Dependent Variable

Analysis of earnings management most often focuses on management’s use of discretionary accruals (see for example, Healy 1985; DeAngelo 1986; Jones 1991). The accrual basis of accounting—matching revenues and expenses to the period in which they were earned or incurred respectively—allows management some discretion regarding the timing and magnitude of revenues and expenses to be recorded in a given accounting period. Management of accruals is viewed as a mechanism for smoothing the firm’s income stream, possibly lowering the firm’s cost of capital (Dechow et al. 1995), as well as a deviant mechanism for CEOs wishing to protect the endowed value of their stock options.<sup>6</sup> Dechow et al. (1995) developed a model that estimates the value of discretionary accruals, augmenting a previous model developed by Jones (1991) by controlling for financial performance and including an estimate of revenue accruals. This modified Jones model has subsequently been used extensively in the finance literature to estimate discretionary accruals as a means of detecting earnings management. Various studies have identified situations where discretionary accruals are likely to be used to either decrease or increase earnings to suit the needs of executives choosing. For example, Healy’s (1985) seminal research on earnings management and compensation design found that executives decrease earnings using discretionary accruals when earnings are either below a lower bound or cash from operations is above the upper bound of top executive bonus plans.

<sup>6</sup> The use of discretion by management in determining accruals is generally lawful and thus falls under the definition of earnings management in the extant literature. However, there will be situations where accruals are used outside of the limits of the GAAP and thus fall under the definition of earnings manipulation.



Data for calculation of discretionary accruals is taken from Compustat. We calculate discretionary accruals using the modified Jones model developed by Dechow et al. (1995). We first estimate total accruals (TA) and non-discretionary accruals (NDA), controlling for firm performance, and then calculate discretionary accruals as the difference between the non-discretionary accruals and total accruals. The modified Jones model for NDA is estimated as

$$NDA_t = \alpha_1(1/A_{t-1}) + \alpha_2(\Delta REV_t - \Delta REC_t) + \alpha_3(PPE_t), \quad (1)$$

where  $\Delta REV_t$  is the revenues in year  $t$  less revenues in year  $t - 1$ , scaled by total assets at  $t - 1$ ;  $\Delta REC_t$  is the receivables in year  $t$  less receivables in year  $t - 1$ , scaled by total assets at  $t - 1$ ;  $PPE_t$  is the gross property plant and equipment in year  $t$ , scaled by total assets at  $t - 1$ ;  $A_{t-1}$  is the total assets at  $t - 1$ ; and  $\alpha_1, \alpha_2, \alpha_3$  are the firm specific parameters.

Estimates of  $\alpha_1, \alpha_2,$  and  $\alpha_3$  are generated using the following model:

$$TA_t = a_1(1/A_{t-1}) + a_2(\Delta REV_t - \Delta REC_t) + a_3(PPE_t) + e,$$

where  $a_1, a_2,$  and  $a_3$  denote the OLS estimates of  $\alpha_1, \alpha_2, \alpha_3,$  and TA is total accruals scaled by lagged total assets. We require a minimum of 6 years of data for each firm to be included in the model. Consistent with previous studies of earnings management (Healy 1985; Jones 1991), total accruals (TA) are calculated as

$$TA_t = (\Delta CA_t - \Delta CL_t - \Delta Cash_t + \Delta STD_t - Dep_t)/A_{t-1}, \quad (2)$$

where  $\Delta CA$  is the change in current assets;  $\Delta CL$  is the change in current liabilities;  $\Delta Cash$  is the change in cash and cash equivalents;  $\Delta STD$  is the change in short-term debt;  $Dep$  is the depreciation and amortization expense; and  $A$  is the total assets.

Discretionary accruals (DA) are then calculated by deducting NDA from TA. Note that similar to NDA and TA, DA are scaled by lagged total assets, and is calculated as per below for firm  $i$  in year  $t$ :

$$DA_{it} = TA_{it} - NDA_{it}. \quad (3)$$

Dechow et al. (1995) established that the modified Jones model described above exhibits the most power in detecting earnings management out of a range of competing earnings management models. The modified Jones model is also a significant predictor of qualified audit reports (Bartov et al. 2000), further deeming this model to be a useful predictor of earnings quality and earnings management. Hence, we use discretionary accruals as a proxy for earnings management. For example, positive firm-year discretionary accruals are

indicative that the management has exercised their discretion to manage earnings upward (income increasing).

Discretionary accruals also provide a rich measure of the degree of earnings management, as opposed to the binary and less nuanced approach of using earnings restatements (the latter have been used for example by Harris and Bromiley 2007; Zhang et al. 2008).

### Independent and Moderator Variables

Utilizing the sample and operational definition of Anderson and Reeb (2004), a firm is classified as family-controlled when family ownership exceeds 5 % and/or there are two or more family members on the board (these organizations are labeled as family firms even if they are not wholly owned by a single family). This definition is consistent with a number of papers in extant literature on family firms (e.g., Gomez-Mejia et al. 2003; Villalonga and Amit 2006, 2009). We chose it because it “is the broadest one we can use,” “as it does not require a minimum threshold for family ownership or control above those imposed by SEC reporting requirements” (Villalonga and Amit 2009, p. 3058); thus, it is a lower-bound measure of family firms. Consistent with this literature, we use a *family firm* dummy variable, assigning a value of “1” to family firms and “0” to non-family. Within these family firms, we then assign a value of “1” to firms whose founder is still the CEO (*founder firm*), and a value of “0” to those with non-founder CEOs.

*Firm size* is measured as the natural log of the firm’s total assets (Devers et al. 2008). *Dual-class* stock is a dummy variable, coded as “1” if the firm has more than one class of stock with differential voting rights, and “0” otherwise. *CEO tenure* is calculated as the number of years the CEO has been in this role with the focal firm.

### Control Variables

We control for firm characteristics previously shown to influence discretionary accruals, including *book-to-market ratio* (a measure of acquisition vulnerability; Palepu 1986), *firm performance* (using return on assets), *distress* (calculated based on Ohlson 1980), *liquidity*, and standard deviation of returns (*ROA SD*) over the prior 36 months (Ali et al. 2007; Bartov et al. 2000; Grant et al. 2009). Each of these have been argued by the respective studies to have a material effect upon the benefits a CEO can derive from additional use of earnings management. Given that we are interested in the decision making of family owners as opposed to the CEO, we also control for CEO level factors known to influence earnings management, such as stock ownership and option grants (Harris and Bromiley 2007). *CEO stock ownership* is measured as the number of shares owned by the CEO divided by

the total number of shares outstanding for the firm (Devers et al. 2008). *CEO option grants* is the value of the stock options awarded to the CEO, valued using the Black–Scholes option valuation method (Devers et al. 2008). Industry is controlled for by the inclusion of industry dummy variables. Year dummy variables were also included to control for the influence of specific years upon earnings management and other time-dependent variation, and to resolve the issue of contemporaneous correlation in panel data (Certo and Semadeni 2006).

**Analysis**

Given the panel structure of our data, we require the use of a panel data model. The question of whether a fixed effects model should be used or a random effects model can be used depends on the estimated error term (Wooldridge 2002). The fixed effects model is always consistent, but less efficient; a random effect model is more efficient, but not consistent if the effect being estimated is correlated with the error term. We used the Hausman (1978) specification test on the regressions for each hypothesis, and found that fixed effect models were appropriate for all regressions. Accordingly, all analyses were estimated with the *xtreg* function in STATA with the fixed effects option (*fe*), all using the firm as the grouping variable.<sup>7</sup> It should be noted that a fixed effect model accounts for time-invariant firm-level heterogeneity. We also winsorized all (non-binary) variables at the 1 % level to mitigate the influence of outliers in our dataset. Finally, all non-binary variables have been standardized to reduce the likelihood of multi-collinearity created by the inclusion of the interaction terms. To this end, we also mean centered the variables included in the interactions for the regression.

**Results**

The correlation matrix and descriptive statistics for the unstandardized variables are shown in Table 1. Table 2 shows fixed effect regression model estimates predicting discretionary accruals, our proxy for earnings management. Examining the regression estimations in Table 2, *R*<sup>2</sup> for within firm variance is close to or below 0.10. *R*<sup>2</sup> statistics of this magnitude are standard in discretionary accruals models in accounting research (e.g., Ashbaugh et al. 2003; Bergstresser and Philippon 2006; Chen et al. 2008; Collins and Hribar 2002).

Hypothesis 1 predicts that family firms will use earnings management less than non-family firms. Consistent with

<sup>7</sup> The results are substantively unchanged if we use the *areg* panel estimation procedure.

**Table 1** Descriptive statistics and correlations

	Mean	SD	1	2	3	4	5	6	7	8	9	10	11
1 Discretionary accruals	-0.007	0.122	1.000										
2 Firm performance	0.059	0.053	-0.032	1.000									
3 Distress	1.962	0.784	-0.011	0.186	1.000								
4 Liquidity	0.566	0.431	-0.006	0.047	-0.175	1.000							
5 ROA S.D.	0.032	0.036	-0.043	-0.265	-0.174	-0.014	1.000						
6 CEO stock ownership	0.006	0.018	0.019	0.033	0.014	0.058	0.005	1.000					
7 CEO option grants	2,576.4	4,107.3	0.002	0.028	0.022	-0.148	0.002	-0.030	1.000				
8 Book-to-market	0.383	0.217	-0.041	-0.328	-0.122	0.215	-0.052	-0.007	-0.204	1.000			
9 Firm size	8.300	1.130	0.020	-0.008	0.136	-0.265	-0.179	-0.139	0.316	-0.100	1.000		
10 Family firm	0.318	0.466	-0.010	0.122	0.037	0.090	-0.014	0.358	-0.083	-0.017	-0.191	1.000	
11 Dual-class stock	0.056	0.230	0.034	-0.018	0.005	0.017	0.035	0.155	-0.047	0.021	-0.131	0.287	1.000
12 CEO tenure	6.283	6.786	-0.033	0.026	0.053	0.056	-0.016	0.201	0.023	0.042	0.016	0.169	0.115

*N* = 1,149; All correlations greater than the absolute value of 0.06 are significant at *p* < 0.01

**Table 2** Fixed effect regression models predicting discretionary accruals

	Controls		Model 1		Model 2		Model 3	
			Main effects		Main effects		Interactions	
			Family		Founder		Family	
	$\beta$	SE	$\beta$	SE	$\beta$	SE	$\beta$	SE
Firm performance	-0.032	(0.048)	-0.035	(0.048)	-0.152†	(0.090)	-0.044	(0.048)
Distress	-0.080	(0.100)	-0.061	(0.100)	-0.094	(0.198)	-0.041	(0.100)
Liquidity	-0.176†	(0.106)	-0.140	(0.107)	-0.243	(0.202)	-0.141	(0.107)
ROA SD	-0.070	(0.046)	-0.069	(0.046)	-0.154†	(0.090)	-0.074	(0.046)
CEO stock ownership	-0.206*	(0.100)	-0.159	(0.102)	-0.036	(0.113)	-0.099	(0.104)
CEO option grants	-0.042	(0.041)	-0.044	(0.041)	-0.006	(0.072)	-0.036	(0.040)
Book-to-market	-0.082	(0.075)	-0.138†	(0.076)	-0.317*	(0.159)	-0.125	(0.076)
Firm size			0.476*	(0.226)	0.330	(0.506)	0.360	(0.238)
CEO tenure			-0.010	(0.009)	-0.008	(0.019)	-0.002	(0.010)
Dual-class stock			0.076	(0.175)	0.506†	(0.287)	-0.194	(0.235)
Family firm			-0.564*	(0.231)			-0.275	(0.255)
Founder firm					-1.526*	(0.764)		
Family × firm size							0.486*	(0.223)
Family × CEO tenure							-0.032†	(0.019)
Family × dual-class							1.225†	(0.697)
Constant	0.047	(0.080)	0.197	(0.119)	0.276	(0.235)	0.148	(0.120)
R <sup>2</sup> within	0.019		0.033		0.099		0.045	
N	1,149		1,149		346		1,149	

†  $p < .10$ , \*  $p < .05$ , \*\*  $p < .01$ , \*\*\*  $p < .001$ ; Year and industry fixed effects are included in all models

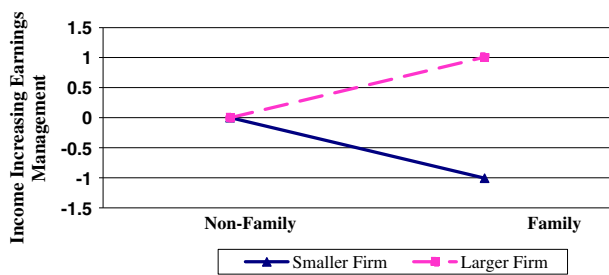
this prediction, the family firm indicator variable in Model 1 is significant and negative ( $p < 0.05$ ,  $b = -0.564$ ), supporting Hypothesis 1. Because non-dummy variables are standardized, this suggests that family firms on average will manage earnings by 0.564 of one standard deviation less than non-family firms. Given that discretionary accruals are scaled by total assets and the standard deviation is 0.122, family firms will manage earnings by approximately 7 % of the firm's assets less than non-family firms when reporting annual earnings. As such, the family-firm effect is not only statistically, but also practically significant.

Hypothesis 2 predicts that founder firms are less likely than non-founder family firms to use earnings management. Supporting Hypothesis 2, the founder firm dummy in Model 2 of Table 2 is a significant ( $p < 0.05$ ;  $b = -1.526$ ) and negative predictor of earnings management within the sample of family firms. That is, our findings suggest that founder firms are less likely than non-founder family firms to manage earnings. Using the same calculations as we have for Hypothesis 1, this suggests that founder firms manage earnings by approximately 19 % of assets less than non-founder family firms. This underscores that the difference between founder-controlled and non-founder family firms is indeed practically (economically) significant.

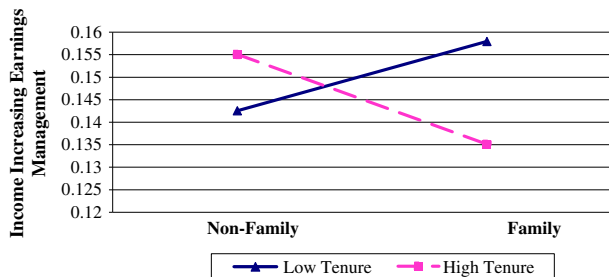
Hypothesis 3 predicts that family firms are more likely to use earnings management as the size of the firm increases. Model 3 of Table 2 shows a significant ( $p < 0.05$ ) and positive interaction between the family firm dummy variable and firm size. Consistent with Hypothesis 3, we find that as the family firm grows, the use of earnings management increases accordingly. Figure 1 graphically depicts this finding; when the family firm is smaller, its use of earnings management is much lower than that of the non-family firm. However, as the firm gets larger, the gap between family and non-family firms in the use of earnings management narrows.

Hypothesis 4 predicts that CEO tenure will accentuate or reinforce the negative effect of family ownership upon earnings management. The negative coefficient on the family firm indicator and CEO tenure interaction in Model 3 of Table 2 shows that this is weakly supported ( $p < 0.10$ ); the relationship is represented graphically in Fig. 2. Hypothesis 5, which predicts that the negative effect of family ownership on earnings management is weaker where the family firm has adopted a dual-class stock structure, is also marginally supported ( $p < 0.10$ ), based on the interaction coefficient in Model 3 of Table 2.

We further tested whether or not it made a difference that the CEO was not a family member by excluding firms



**Fig. 1** Interaction between family firm status and firm size



**Fig. 2** Interaction between family firm status and CEO tenure

with family CEOs from our sample. This allowed us to isolate the influence of dominant family owners in the earnings management decision and eliminate the possibility that the family CEO status was responsible for our results (i.e., showing the differences in earnings management between family and non-family firms, and the moderating effect of CEO tenure). The results reported here remain essentially unchanged, independent of the CEO's family status.

## Discussion

This study aims to explain choices of the dominant family owners, relative to their non-family counterparts, in the earnings management decision. We have four main findings. First, we find that family firms engage in less earnings management relative to non-family firms. Second, founder firms are even less likely than later generations of family owners to rely on income increasing earnings management. Third, family firms are more likely to engage in earnings management, and thus, risk being perceived as unethical as firm size increases. Finally, increasing CEO tenure accentuates the difference between family and non-family earnings management, while the creation of dual classes of stock attenuates that difference. These findings provide important theoretical insights, which we elaborate upon below.

Our findings suggest that family owners are more likely to avoid unethical use of earnings management, which we

argue is due to its anticipated effect upon the family's stock of socioemotional wealth. While various family business studies have examined related themes, such as corporate citizenship and corporate social responsibility practices of family firms (Berrone et al. 2010; Dyer and Whetten 2006), research examining ethical decision making by family owners has been underdeveloped (Gomez-Mejia et al. 2011). By demonstrating that family firms do indeed prefer more ethical standards in the reporting of accounting information, we provide a valuable contribution to family business literature and specifically, we advance knowledge regarding ethical decision making within family firms. In doing so, we also build upon research suggesting that family firms are more concerned with the reputational consequences of their decisions and are more likely to be better corporate citizens than their non-family counterparts. Recognizing that there is likely to be heterogeneity across family firms' concern for reputation, we also provide a theoretical framework for predicting when family firms are likely to be concerned with the reputational consequences of earnings management. We have used the existence of a dual-class stock structure as a proxy for the family principals' concern for the reputational implications of unethical conduct. This provides value from both a research and practical perspective, by enhancing our ability to predict the likelihood of family firms subordinating reputational concerns to other family goals.

We advance the literature utilizing the concept of socioemotional wealth to explain significant organizational decisions that differentiate family from non-family-controlled firms. Thus, we further extend prior research leveraging socioemotional wealth as a construct to explain differences between family and non-family firms on numerous strategic choices that have included risk taking (Gomez-Mejia et al. 2007), diversification (Gomez-Mejia et al. 2010), pollution prevention (Berrone et al. 2010), and research and development (R&D) investments (Chrisman and Patel 2012). In particular, our study of the differences in earnings management preferences between family and non-family firms used the socioemotional wealth construct to delve further into the likelihood that family firms will engage in unethical business practices.

Despite the ubiquity of family owned firms, the nature of agency problems afflicting these firms remains underdeveloped. This remains the case since the lament of Schulze et al. (2001) over a decade earlier regarding the lack of understanding of governance issues within family firms. We address this research gap by providing important insights regarding agency problems deriving from (1) earnings management that distorts incentive alignment and firm investment decisions (i.e., moral hazard); and (2) conflict between principals or shareholder groups (i.e., principal-principal conflict), amplified in the context of



family firms. The agency problem associated with conflict between principals arises when there is a conflict between shareholder groups with divergent goals (c.f. Morck and Yeung 2003). The divergent goals with regard to socioemotional wealth preservation should also be evident between family owners and non-family minority shareholders within the family firm, given the former are more concerned with affective utilities than the latter. That is, socioemotional wealth-preservation motives of dominant family principals are likely to conflict with the more economic orientation of non-family minority principals. Moreover, non-family (minority) principals have little downside due to earnings management, as they can cut their losses and disassociate with the firm almost instantly. This route is less available to family owners, who would be forced to suffer through the long-term reputational consequences in order to avoid distinguishing their socioemotional investment in the firm. Thus, the demonstrated difference in earnings management preferences between family and non-family firms herein highlights the existence of principal–principal (i.e., Type II) agency problems within family firms. In explaining the likely occurrence of these agency problems within family firms, we advance corporate governance literature in this domain.

We also provide insights into the principal–agent (i.e., Type I) conflict associated with the management of earnings within family firms. Jensen and Meckling (1976) suggested that owner managed firms, such as family firms, should be less prone to agency costs. While this has been challenged by suggestions that family firms experience unique and possibly more complex agency problems (e.g., Schulze et al. 2001, 2003), empirical tests of these propositions and evidence of unique family-centric agency costs have been more limited. Exceptions include Schulze et al. (2001), who found that pay incentives are also important for incentivizing family firms, and Schulze et al. (2003), who examined the double moral hazard problem where family siblings seem to enhance their wealth at the expense of the remainder of the family. Similarly, Gomez-Mejia et al. (2001) found further evidence of principal–agent conflict within family firms, given that non-family contracting is more likely to hold the executives accountable, and that CEO dismissal is more likely to be associated with positive performance effects when they are replaced by non-family counterparts. We contribute to this literature by utilizing an alternative theoretical framework—the family firm socioemotional wealth literature—in order to explain how family principals (dominant family owners) monitor their CEOs more closely relative to non-family principals, limiting agency costs within family firms.

The study of differences in decision making across generations of family owners—in particular, differences between founders and later generations—has been advanced by various family firm scholars. For instance, Le

Breton-Miller and Miller (2008) draw upon the entrepreneurial literature to argue that founders are more likely to follow a “build” strategy such as growth and innovation, while future generations tend to follow a “harvest” strategy to enjoy the fruits of past successes. A parallel literature suggests that family business founders are more likely to be emotionally attached to the firm than later generations, and therefore more concerned with socioemotional wealth preservation (Gomez-Mejia et al. 2007; Gils et al. 2004; Westhead 2003). Our study advances this debate by suggesting that if socioemotional wealth is stronger at the founder stage, these owners should be even more loss averse to socioemotional wealth losses as a result of earnings management than firms at later family stages.

Socioemotional wealth literature has long argued that family firms avoid strategic choices that grow the firm—such as acquisitions (Miller et al. 2010)—given the loss of control that is assumed to result from such growth (for a review of this literature, see Gomez-Mejia et al. 2011). For instance, the infusion of external expertise and capital associated with firm growth has been argued to reduce the family’s socioemotional wealth. However, extant research fails to directly examine or empirically verify the dilutive effect of firm size upon family socioemotional wealth. We advance this discourse by demonstrating that firm size does indeed reduce the intensity of family socioemotional wealth as manifested in family principal’s lower inclination to limit the use of earnings management as the firm grows. This finding is in contrast to the firm prominence or visibility explanation—larger firms are more visible and subject to greater scrutiny, making it more likely that earnings management will be discovered; yet, they appear to use this practice more heavily than smaller firms (consistent with our theory). Taken together with our findings regarding founder firms, our study suggests a life-cycle effect within family firms, where firms in later stages—manifested by either growth in firm size or passing of the firm to descendants—experience dilution of socioemotional wealth, leading to behaviors more akin to those of non-family firms.

Our findings with regard to CEO entrenchment—accentuating the family-firm effect upon earnings management—offers valuable insights into the relationship that may develop between the family principals and their CEO. Regardless of whether the CEO is family or non-family, a long-standing relationship is likely to reflect trust and the existence of mutual obligation between the CEO and the greater family unit. This also suggests that the CEOs’ emotional attachment to their firm may grow over time, making them more likely to identify strongly with their firm and protect its reputation more so than CEOs with shorter tenure. Said differently, long tenured CEOs may find it more difficult to disentangle themselves and their

personal reputation from the negative consequences of a damaged firm reputation. Interestingly, this CEO tenure effect may provide a counter-balance to the dilution of socioemotional wealth that is expected with the passing of time—over the life cycle of the family firm—due to inter-generational changes and firm growth.

Finally, our study contributes to research examining earnings management behavior within family firms. Specifically, we allay the fears of Fan and Wong (2002) who argue that lack of transparency through poor quality of reported earnings (that may stem from the use of earnings management techniques) allows the dominant family shareholders to expropriate wealth from the minority shareholders. In fact, we show the opposite effect, with dominant family members helping ensure that the firm does not engage in earnings management. Studies of family firm earnings management have previously been mostly confined to the accounting and finance literatures drawing upon a limited theoretical base—primarily agency theory.<sup>8</sup> To our knowledge, our study is the first comparative study of earnings management in family and non-family firms using the theoretical lens of socioemotional wealth and dominant owners. In doing so, we build a more textured understanding of the family owner's loss aversion with regard to socioemotional wealth and its effects upon firm behavior. This provides important theoretical contributions to the family firm, socioemotional wealth and earnings management literatures.

#### Limitations and Future Directions

Like all studies, our paper has limitations, which also provide opportunities for future research. First, although we use the widely accepted Anderson and Reeb (2004) measure of family ownership, which uses a 5 % threshold and board membership criteria, future research could further examine the earnings management decision using different thresholds. Second, we are also restricted in terms of the time period under consideration, given the limitations of our data source. Last, we have not measured socioemotional wealth directly, but rather used it as a theoretical construct to explain the depressing effect of family ownership on earnings management. It should be noted that this is not unique to this study, as several recent studies have used socioemotional wealth in a similar fashion to predict a variety of family firm phenomena, such as pollution (Berrone et al. 2010), diversification (Gomez-Mejia et al. 2010), acquisitions (Miller et al. 2010), firm valuation (Zellweger et al. 2012), and R&D (Chrisman and Patel 2012). Likewise, we are not aware of any studies that

<sup>8</sup> The exception is Stockmans et al. (2010), who have applied socioemotional wealth to the study of CEO decision making in the earnings management decision (as opposed to the role of the family owners as dominant shareholders) with a focus upon how generational differences influence CEO earnings management within family firms.

have measured agency costs directly; rather, its use remains at a conceptual level to interpret observed organizational phenomena (for a recent attempt to proxy for agency costs, see Campbell et al. 2012). With these caveats in mind, future research should try to obtain direct indicators of socioemotional wealth through surveys, interviews, case studies, or text analysis (see Berrone et al. 2012).

As a final point, some may argue that family firms avoid higher levels of earnings management because it is risky, and hence agency theory would predict that an owner with concentrated wealth would tend to act in a more conservative fashion. However, the risk-driven explanation is in contrast to our finding that founder firms, which are argued to have an entrepreneurial, and thus, risk-taking orientation, are the least likely to engage in this behavior. This finding, however, is consistent with a socioemotional wealth-preservation explanation. While nobody is exactly sure of the threshold that needs to be crossed to incur the reputation damage associated with earnings management, our hypotheses and results indicate that family firms will not “push their luck” in the earnings management gamble as non-family firms do.

#### Concluding Comments

This study adds to the growing literature on socioemotional wealth that suggests family principals use a different set of non-economic utilities to make decisions. Given the growing importance of ethics as an academic area of inquiry (e.g., Donaldson 2012; Hernandez 2012; Mayer et al. 2012) and the preponderance of family firms around the world, our extension of the socioemotional wealth model to the earnings management literature suggests that socioemotional wealth offers much hope as an analytical approach to understand why some firms are more likely to behave in an ethical fashion than others.

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