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FAMILY OWNERSHIP AND REAL EARNINGS MANAGEMENT

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Abstract: *This paper reviews on previous studies considering real earnings management issues and family ownership. Concentrated ownership such as family ownership is proposed to deal with agency problem. It happens from conflicts of interest that may emerge in contractual relationships when a contract is incomplete between the controlling owners and the minority shareholders to pursue their private benefits. To camouflage the effect of expropriation, family owned companies may manage their earnings. Earnings management has strong association with private benefit consumptions in relatively weaker investor protection countries. Interestingly, this paper identified how and why family ownership use real activity earnings management in meeting their desired goals. It is recommended that more empirical study should be done to assess the overall characteristics of ownership and real-activity management in order to gather new inputs.*

Keywords: *Real earnings management, family ownership, agency theory.*

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1. Introduction

Corporate governance in Malaysia is highly governed by ownership structure which affects board composition, board practices and board decisions (Tan, 2005). There are various types of shareholding in Malaysian companies (Abdul Samad, 2004; La-Porta et al., 2000). Interestingly, majority of the Malaysian companies' shareholdings are either individual or family (Ishak and Napier, 2006).

With regards to Malaysian ownerships structure, there is a significant involvement by owners in the companies. About 33% of them involve in administering and governing management process (KLSE-PWC, 1999). Apart from that, shareholdings in Malaysian companies are owned by family members and it is the largest structure being owned. Family has the highest control in large companies (35%) and smaller companies (84%). Additionally, it is important to note that Malaysian companies are also owned by institutional and foreign shareholders (Claessens et al., 2000; Joher, Ali, and Nazrul, 2006; Suto, 2003).

Approximately, 71.4% Malaysian companies are concentrated by majority ownership which has more than 50% shareholdings and being organized by the companies' top five largest

shareholders. The percentage shareholding by type of five largest shareholders is dominated by nominees followed by non-financial companies and government. As such, it reveals that Malaysian companies are controlled by large shareholders and thereby protection of minority shareholders might create an issue in Malaysia since minority shareholders have less power to prevent large shareholders from implementing their plans and controls over the company (Claessens et al., 2000).

Lemmons and Lins (2003) report that companies' ownership structure is a major factor that creates agency problems between owners and external investors. Nowadays, earnings management practices are issues that are being focused by academic researchers, policy makers, and accounting practitioners since it happened due to agency problem. It is done in achieving desired earnings' goal.

2. Family Ownership

A company that is controlled and managed by family members is known as family ownership business (Anderson and Reeb, 2003). Family firms are unique because the company is owned by the family for a long time and the family connects its reputation to the firm (Chen, Chen and Cheng, 2008), which gives the firm an extra objective to avoid negative publicity. The most important motive for keeping the reputation of the firm is the dynastic motive (Casson, 1999).

Usually, family owned companies produces motives for monitoring shareholders to expropriate other shareholder fortune (Fama and Jensen, 1983; Shleifer and Vishny, 1997). This is because family members may take out particular advantages from the company at the minority shareholders' cost. In family owned companies, family members are the persons who hold significant positions on board as well as management team. As such, it might create ineffective monitoring which will lower corporate governance. Moreover, there are higher information asymmetry between shareholders and family ownership. Accordingly, family members have the opportunity as well as the incentive to manage earnings for their own benefits. Thus, family ownership is related to inferior reporting quality.

Consequently, it cannot be denied that family companies with a concentrated ownership do face agency problems between the controlling shareholders and the minority shareholders and the threat of expropriation of minority shareholders' rights may become a reality. Family companies can make sub-optimal investment decisions since the interests of the family are not necessarily in line with those of other shareholders (Fama and Jensen 1985). Moreover, restricted ownership reduces external governance and highlights the problems of self-control that arise when a firm is headed by a powerful owner/manager or because family relationships tend to make agency problems more difficult to resolve (Schulze, Lubatkin, Dino and Bucholtz 2001).

Generally, family member not only hold a stipulated and stated ownership on share of the companies but also handle and stay as boards members of firms. Ali et al. (2007) pronounce the negative impact on the arrangement primarily in disclosing accounting income since management by family members may exploit accounting numbers, for instance, the related party transaction and other activities which transfer wealth from firms to family members. The conflict of interest within family owners and other shareholders has made companies to disclose less voluntary information in the annual report.

In this sense, Fan and Wong (2002) published inferior earnings response coefficients for companies with higher ownership concentration in East Asian countries. This evidence specified that superior family ownership produces more information asymmetry that causes agency conflict, causes minority shareholders' legal protection to be weak, and puts into effect the transparency of financial reporting quality to become lower.

In contrast, there also studies which find that family owned companies tend to have strong incentive to decrease agency costs and increase the firm value. This is because concentrated shareholders have a strong economic incentive to monitor managers and decrease agency costs (Demsetz and Lehn 1985). Since families usually invest most of their private wealth in the company and it is not well-diversified, families are more concerned with the firm's survival and have a strong incentive to monitor management closely. Monitoring costs tend to be lower in companies controlled by family than by non-family and thus improves reporting quality (Fleming, Heaney and Rochelle 2005; Fama and Jensen 1983).

3. Earnings Management

Earnings management can be defined as techniques used by managers through discretion of accounting methods to achieve desired goals. Earnings management happens when managers make changes in financial statement as to deceive the companies' stakeholders regarding the performance of the company and to control the result depending on accounting practices. The intervention can happen by operational decisions and not on the accounting methods and estimates (Healy and Wahlen, 1999).

DeFond and Francis (2005) mention that accounting standards allow the accounting choice to be done, judgment to be made and assumptions by managers in producing the financial statement. Therefore, the rationale and validity depends on the assumption of researchers on the quality of reporting and the level of how the quality being measured. However, earnings management may lead to fraud if it is not being hindered appropriately. This is because there will always be a temptation to inappropriately manage earnings to meet projections that suits everyone (Millstein, 2005).

There are two methods in managing companies' earnings. The first method is through discretion on the ordinary or usual activities of the companies' earnings that may affect the cash flow of the companies. The discretion on the ordinary activities of the companies is known as the real earnings management (REM) (Rowchowdhury, 2006). The second method is when the company modify the accrual activities as to earn the goal of companies' earnings which is known as accrual based earnings management (AEM) (Healy and Wahlen, 1998).

Accrual earnings management (AEM) can be defined as the action of the company in modifying their accrual activities as to achieve the companies' goal in terms of their earnings. Under this situation, managers usually judge the reporting on the financial statements (Healy and Wahlen, 1998). In order to measure the accrual basis of earning management practice, most studies apply Jones's (1991) discretionary accruals with book-to-market value, cash flow from operations and current-year ROA. These models control for firm performance. Prior studies Cohen, Dey and Lys (2008), Dechow, Sloan and Sweeney 1995, and Kothari, Leone and Wasley (2005) have documented that estimated discretionary accruals are correlated with stock price and firm performance measures. The higher the level of the discretionary accruals, the lower the earnings quality gathered.

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In contrast, real earnings management (REM) can be known as the digression on the ordinary activities by the managers in deceiving the companies' stakeholders in terms of companies' earnings as to ensure that the stakeholders believe that the operations are normal and meet the desired goal of the companies. The best example that can be seen is in terms of the discount on prices and the cutting on expenses of the companies. Nevertheless, if managers always involve in the activities with the purpose of enhancing the desired goal of earnings, then it said that the managers are engaging with real earnings manipulation (Rowchowdhury 2006). Additionally, Chen, Chen, Lobo and Wang (2011) reveal that managers tend to use real earnings managements in manipulating the companies' earnings rather than discretionary accrual basis. Rowchowdhury (2006) explains that he uses these methods in measuring real earnings management (REM) of the companies. The first method is through examining the discounted price of a company. The discounted prices are to boost the companies' sales. The second method is through involving in overproduction as lessening the cost of goods sold (COGS) and the last method is through decreasing the discretionary expenditures in large amount as to enhance the companies' profit.

4. Family Ownership and Real Earnings Management

Prior studies examine earnings quality of family firms focusing on accrual earnings management (Ali, Chen and Radhakrishnan, 2007; Ding, Qu and Zhuang, 2011; Fan and Wong, 2002; Wang, 2006). However, Graham, Harvey, and Rajgopal (2005) report that managers prefer real earnings management (REMs) activities compared to accrual-based earnings management. Hence, Roychowdhury (2006) concludes that companies use various accounting activities known as real earnings management to meet definite income goals. There are various determinants that enhance and mitigate real earnings management practices. Surprisingly, there is a lack of research pertaining to family ownership and real earnings management despite the fact that family firms offer an interesting experimental for the investigation of real earnings management practices. Consequently, it may be argued that activities that result in REMs are more easily facilitated in family firms and has potential adverse effect of deviating from regular operational and investment activities.

Actually, both family and non-family firms have tendency towards earnings management. However, the underlying motives are quite different. While in widely-held firms' earnings management is mostly driven by the desire to smooth earnings and to influence management compensation, the dominant motive in family-owned firms is to stay in control of the company, i.e. to avoid the breach of covenant clauses (Prencipe et al., 2008), and to pay smooth dividends (Schmid et al., 2010).

Interestingly, Achleintner, Gunther, Kaserer, and Siciliano (2014) reveal that family firms are less likely to engage in real management practices, which is perhaps indicative of the fact that family owners are less likely to jeopardize the long term prospects of their investments in the firms. Hence, the issue of REMs in family firms merits empirical investigation. One strand of research argues that family firms demonstrate better earnings quality compared to non-family firms (Ali et al., 2007; Wang, 2006). Claessens, Djankov, Fan, and Lang (2002) and Fan and Wong (2002) contend that family firms generally have lower quality accounting information. This lack of generalizability of the findings on earnings quality in family firms mostly revolves around the accruals earnings management measurements.

Nevertheless, there are evidences that earnings management is not limited to accruals management only but may involve real earnings management (Cohen, Dey and Lys, 2008; Cohen and Zarowin, 2010; Graham et al., 2005; Gunny, 2010; Roychowdhury, 2006; Zang, 2012). This is because real earning management involves manipulation of real activities to meet some earnings benchmark that may result in sub optimization of firm's resources. It impacts companies' long term cash flows (Roychowdhury, 2006) and it is less susceptible to external scrutiny.

Consequently, family owned companies offer an interesting avenue for more investigations to be done pertaining to real earnings management since the companies are governed by active family member as managers in their companies (Anderson and Reeb, 2003). As a consequence, they might enjoy greater latitude in altering regular operational and investment activities. Such actions are less likely to be contested by the professional managers since they serve the family interests (DeAngelo and DeAngelo, 2000). Accordingly, real earnings management is done through alteration of regular operational and investment decisions through activities of managing cash flow, discretionary expenses and production value of a company. These actions might turn out to be a more convenient option for family owned companies but this facilitation may be negated by the concern for potential adverse impact of real earnings management in long term period (Cohen and Zarowin, 2010; Graham et al., 2005; Roychowdhury, 2006).

The issue of real earnings management in family owned companies is a compelling one to examine empirically. Despite this, REMs in family firms is heavily under researched. The issue of REMs in family firms may be of greater interest in weaker investor protection regimes. The poor legal protection for investors has been found to be positively related to poor quality reported earnings (Leuz et al., 2003). Insiders are more likely to acquire private benefits in such environment and this in turn induces them to manage earnings to conceal their activities (Leuz et al., 2003)

5. Conclusion and Recommendation for Future Studies

Studies involving family firms are very timely, because it is an emerging focus, whose impact is considerable. Several studies have discussed family businesses. However, most of the studies focus on firm performance and accrual based earnings management. There is lacking of studies pertaining to ownership structure and real earnings management. Shockingly, to date, the issue of real earnings management is being focused by academic researchers, policy makers, and accounting practitioners since it is classified as a "mystical behaviour" conducted by most companies in achieving their desired earnings' goal. As such, further research should focus on the concerns prompted by the fact that the company has a family-type control. It is believed that family-owned companies tend to affect financial reporting quality. Hence, the importance of this study is to identify how and why family ownership use real activity earnings management in meeting their desired goals. As such, it is recommended that more empirical study should be done to assess the overall characteristics of ownership and real-activity management in order to gather new inputs.

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