Earnings Management and Contests for Control: An Analysis of European Family Firms

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Abstract
In this paper, the influence of large shareholders on earnings management in family-owned firms is analyzed using a sample of firms from nine European countries. How contests for control for the largest shareholder and the existence of a controlling coalition in family-owned firms affect earnings management is considered. It was found that increases in the contestability of control by the largest shareholder reduce earnings management in family-owned firms. The results also show that in firms in which the largest shareholder is a family member, a second or third family shareholder increases discretionary accruals.

Keywords: corporate control, discretionary accruals, earnings management, family firms

JEL Classification codes: G32, M41

The discretionary behavior of managers is one area of capital markets that has made the greatest contribution to knowledge in accounting. Managers can improve or impair the quality of financial statements through a number of actions such as voluntary disclosure, choice of accounting methods, and estimation of accruals. Broadly speaking, earnings management can be defined as a strategy used by the management of a company to modify the firm’s earnings so that the figures match a predetermined target. The practice is usually carried out for the purposes of income smoothing. Thus, rather than having years of exceptionally good or bad earnings, companies are able to keep the figures relatively stable by adding and removing cash from reserve accounts. Because motives for earnings management may be opportunistic, attempts to smooth over earning can be perceived as detrimental to the interests of some stakeholders (Beaver & Engel, 1996; DeChow & Skinner, 2000). Although the abuse of earnings management can be punished by authorities, proving such abuse is not an easy task. Therefore, accounting research has focused on methods to detect earnings management, which often has been linked to the mechanisms of corporate governance that potentially affect managers’ discretionary behavior (Bharath, Sunder, & Sunder, 2008; Doyle, Ge, McVay, 2007; Zhao & Chen, 2008) and the institutional framework (Burgstahler, Hail, & Lueck, 2006; Dargenidou, McLeay, & Raonic, 2007; Gabrielsen, Gramlich, & Plenborg, 2002; Leuz, Nanda, & Wysocki, 2003). For instance, in the literature, the following has been studied: effect of the size and composition of the board of directors (Beasley 1996; Peasnell, Pope, & Young, 2005; Xie, Davidson III, & DaDalt, 2003), the audit committee (DeFond & Jiambalvo, 1991; Klein, 2002), managerial ownership (Cheng & Warfield, 2005; Gabrielsen et al., 2002), external auditors (Becker,
DeFond, Jiambalvo, & Subramanyam, 1998; DeFond & Subramanyam, 1998), and institutional investors (Jiambalvo, Rajgopal, & Venkataraman, 2002). Nonetheless, the effect of ownership on earnings management remains a relatively unexplored topic.

We contribute to this line of research by analyzing how the distribution of power among shareholders is related to earnings management. Because one of the main ways to acquire power in firms is through ownership, the focus is on the ownership structure and the effect of the presence of different, large shareholders on the incentive to manage earnings. In most European firms, the main agency problem is agency problem II, which is the result of conflict between controlling and non-controlling shareholders (Becht & Roell, 1999; Bozec & Laurin, 2008; Johnson, Porta, Lopez-de-Silanes, & Shleifer, 2000). An agency II problem seems to be more prominent in family-owned firms in which control is aligned with ownership, and minority shareholders face the possibility of expropriation by large shareholders who often have family ties with managers (Ali, Chen, & Radhakrishnan, 2007; Villalonga & Amit, 2006). In such situations, the contest for control by the dominant shareholders becomes a key issue (Bennedsen & Wolfenzon, 2000; Lehmann & Weigand, 2000; Maury & Pajuste, 2005; Volpin, 2002).

The analysis for this notion of contest, that is, how other large shareholders can challenge the power of the largest shareholder (Laeven & Levine, 2008). Contest, or rivalry, is the motivation among stakeholders to form coalitions to challenge the power of dominant managers, directors, or shareholders. Coalitions shift as individual stakeholders continually seek out the most advantageous relationships to obtain greater power. The model is consistent with the approach of financial agency theory whereby firms are sets of relationships among stakeholders with conflicting interests. In the financial agency framework, large shareholders can play a dual role. Although shareholders have incentives to extract private benefits by expropriating minority shareholders’ wealth, their high stake in the ownership of the firm gives them incentives to improve the firm’s performance. Thus, the role of large shareholders and the formation of controlling coalitions within a firm are vital and can have an asymmetric influence on a firm’s strategic decisions (Bloch & Hege, 2001; Claessens, Djankov, Fan, & Lang, 2002; Gomes & Novaes, 2005).

In this study, how the distribution of ownership and the contest for control of the largest family shareholder impacts the earnings management of family-owned firms is examined. Using a sample of 590 firms from 9 European countries, the results show that the distribution of control among several blockholders reduces earnings management in family firms. Moreover, coalitions among families or individual shareholders reduce the quality of financial statements by triggering earnings management. The results are coherent and extend previous research in a number of ways. First, consistent with Jung and Kwon (2002) and Yeo, Tan, Ho, and Chen (2002), the outstanding role played by large shareholders in overseeing managers’ accounting decisions is corroborated. Second, consistent with Ali et al. (2007), Bona, Pérez, and Santana (2007), Siregar and Utama (2008), and Wang (2006), the importance of family ownership in the willingness to declare earnings, or informativeness, was confirmed. Third, the suitability of a balanced ownership structure among several large shareholders was shown, which is consistent with the findings of Maury and Pajuste (2005) and Jara-Bertín, López-Iñurrigi, and López-de-Foronda (2008) that a more equal distribution of votes among large blockholders has a positive effect on firms’ value.

The contribution of the paper is twofold. First, no study that examines the influence of shared control on earnings management was evident in literature searches; a specific channel through which ownership structure can modify earnings management is demonstrated through this study. In addition, the results of the study may assist in the design of some mechanisms of corporate governance aimed at improving firms’ performance and transparency in capital markets. Second, prior literature has focused primarily on data from a single country (mainly the United States but also Korea, Singapore, and Spain); in this study, research into a multinational context is expanded. In so doing, it is shown that the influence of a controlling coalition is not a country-specific issue but rather, is common to a number of Western European firms.

The remainder of the paper is organized as follows. In the next section, the hypotheses concerning the relationship between abnormal accruals and contests for the control of family shareholders are developed. In Section III, the sample and data are described. Section IV contains the research design and empirical results. In Section V, we summarize and conclude.