Are Family firms in India managing their Earnings – An exploratory study

Working Paper

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in UK to about 95% in Latin America, India and the Far and Middle East[4]. In the US, family firms on an average comprise 33% of the S&P 500 (Anderson & Reeb 2003). Indeed the governance of the organization is influenced by its ownership structure. Research has shown that corporate governance characteristics such as concentrated shareholding influences the quality of financial reporting (Ball & Shivkumar 2005, Burgstahler et al. 2006). Better earnings reporting practices would be a consequence of good corporate governance practices at firms. But if we look at the initiation of corporate governance norms, these primarily focused on safeguarding the interests of the shareholders (for widely held firms) by the management. Thus there is a need to look at corporate governance norms for family businesses differently as we have here family interests (both ownership and control) quite distinct from the minority shareholder interests, famously known as the principal-principal problem.

The concept of dispersed ownership in corporate organizations as initiated by Berle & Means in 1932 highlighted the principal agent relationships and related agency problems (Agency problem I as defined by Villalonga & Amit, 2006). In order to safeguard the interests of the minority shareholders, effective corporate governance norms related to monitoring of management and board sub committees were emphasized upon. However, with family businesses in majority, the concept of widely held corporate organizations as advocated by Berle & Means is a rarity in emerging economies, being mostly characteristics of businesses observed in the US and UK (Shleifer & Vishny 1986, Holderness & Sheehan 1988, Anderson & Reeb 2003). It was believed that with family businesses in majority, the problem of self interested managers in compromising with the long term welfare of the firm would be addressed. Thus Agency problem I would be reduced as family members with substantial shareholding in management position would bring down monitoring cost. This greater insider ownership would in turn generate better corporate governance norms. Owners in managerial positions would not take decisions detrimental to the

2006) researchers were thus interested in exploring their corporate governance attributes and financial reporting practices. In this study we find that family firms in our sample have better corporate governance characteristics and engage in negative (lesser) earnings management proxied by discretionary accruals as compared to the non family firms. We find firms engaging in negative earnings management probably deferring higher earnings recognition in the current period as a tradeoff for meeting benchmarks in the next period. Thus the results found in similar asian contexts (Setia-Atmaja et al., 2009 for Australia, Jaggi et al., 2009 for Hong Kong) have not been corroborated for our sample family firms with regard to their earnings management practices. The reason largely being the considerably higher shareholder concentration of the family stake increasing the horizon of firm decision making, aligning the interests of the owners with that of the firm. Thus the rationale for exploring the issue in the Indian context with the strong 'familiness' comprising of age old culture, family reputation, family values and succession of the business for the next generation (Morck et al. 2000) is well justified.

Family businesses, though are said to bring down the conventional principal agent problem, they may create principal-principal problem with the proliferation of non promoter and institutional

firms may resort to control enhancing mechanisms like risk avoidance[6], excess dividends, 'tunneling[7]' etc. to benefit by expropriating the minority shareholders (Faccio et al. 2001, Anderson & Reeb 2004). The controlling management may dominate the board composition which may not have a fair representation of independent directors (Morck et al. 2004). Thus entrenched family management would be associated with greater incentives for earnings management and poorer quality of earnings. Another competing Alignment hypothesis argues for alignment of interests of the owner managers with interests of the firm as they have longer horizon in business due to considerably higher and lesser diversified ownership stake in the firm. They have the family reputation, culture, family values and succession issues to take care of. Thus family firms will not have the owner managers having private information, misusing these for their own benefit, the tendency common with the managers of the non family firms. They would thus be associated with lower discretionary accruals and better quality of earnings. The argument may well be directed beyond agency problem per se (not type I & type II) to alternative theory of Stakeholder approach to management (Miller et al. 2006). The same extends to financial reporting disclosures in these family firms reporting lower earnings management and better earnings forecasts (A. Ali et al. 2007). The results reported by A. Ali et al.,(2007) support the notion that the alignment hypothesis dominates the entrenchment hypothesis as the difference in agency problem due to type I overpowers the difference in agency problem due to type II leading to lesser positive discretionary accruals for family firms (implying lesser earnings management) as compared to the non family counterparts. However they find that family firms would make fewer voluntary corporate governance related disclosures in favour of a bias in the board composition towards the family effect, to facilitate more family predominance in the board as compared to more independent directors. According to Wang (2006), there are competing forces with regard to both demand for and supply of quality earnings information from family firms in addition to the counterveiling entrenchment and alignment effects. The net impact dominating the result would be context specific and thus is worth exploring to determine whether the entrenchment effect dominates over the alignment effect or it is vice versa. Theory suggests that, if the entrenchment effect predominates, family firms engage in more earnings management (higher discretionary accruals). While if the alignment effect dominates, these firms manage

[6] Accepting even negative net present value projects to avoid risks which influence manager's incentive compensation.

[7] Transferring resources to sister concerns with higher cash flow rights of the owners.

earnings less (lower discretionary accruals). The net impact is in turn influenced by the net strength of demand for and supply of earnings information from the stakeholders too. However the fact whether the family firm ends up providing lesser earnings information (as per the low demand from the stakeholders) in case the alignment effect is primary (thus firms would be prone to provide more earnings information and manage earnings less) would be a function of

Research on earnings management practices by family firms largely subscribe to the view that

with the implementation of the norms in rather than their existence. India does rank at par with most of the developing countries as far as the quality of the regulations are concerned, however strength of the agencies institutionalizing these norms are debatable (Rajesh Chakrabarti..2005). Control pyramids are features of an institutionally deficient economy with concentrated shareholding and family control over businesses in India due to weak protection rights, thereby reducing transaction costs and asymmetric infoTc.395 Tw05 no20.Tj -13(T-2.5602 Tc20.Tj 0T-2.567 Tc.0535

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way of board positions. Thus for our study a family business is one having minimum two adirectors wit

H1: Family firms would have negative association with discretionary abnormal accruals.

In view of the argument laid earlier, with alignment effect overpowering the entrenchment effect for the controlling owners in family firms, they would make a trade off in favor of lower earnings management and supply more informative financial numbers.

H2: Family firms would have better corporate governance attributes as compared to the non family firms.

Effective corporate governance characteristics would strengthen the negative association between family firms and earnings management using discretionary accruals.

Research Design

Sample & Data

Our initial sample is drawn from the population of BSE 200 firms as given in the CMIE Prowess database, using Rutherford et al. (2008) definition of family firms. From this we deleted Banking and Financial services firms[12] (NIC code 64). This gave us a final sample of 948 firm year observations over six years, though the number of observations (firm years) used in the regressions vary as firms which do not have complete information on some of the variables are also removed. Thus all inferences in the study are limited by the given time period and sample firms.

Data related to board of directors characteristics are picked up from the corporate governance report disclosed as a part of the annual report by companies. All other financial and corporate governance variables are collected from Prowess, including the earnings, working capital, cash flow data for computing the abnormal accruals. The final numbers of observations were reduced primarily because we use modified Jones model to estimate the discretionary accruals for each sample firm. The model's parameters are estimated by industry and we require each firm-year to have at least 3 observations with the same two-digit NIC code.

[12] These companies in the banking and finance sector are governed by different set of

Earnings Management – Dependent variable measures

The use of accruals adjustment to proxy for earnings management has been widely used in

ûPPE$_t$ is gross property plant and equipment at the end of year t

ûREC$_t$ is net receivables in year t less net receivable in year t-1.

A_{t-1} is Average total assets at the end of year t-1

$\cdot_1$, $\cdot_2$, $\cdot_3$ are firm specific parameters

0is the residuals

Thus $DAC_t = TA_t$ - Non DAC_t

The data needed to compute abnormal/discretionary accruals like revenue, receivables, property plant & Equipment (PPE), etc. are taken from the CMIE Prowess database. A cross sectional regression model for Jones (1991) is used to estimate the unadjusted abnormal accruals for each firm in the sample. Following the NIC 2 digit classification code and the firm years, the accruals are estimated by OLS with industry and year combination, having at least 3 firms in the industry as a prerequisite.

The main dependent variable thus is discretionary accruals (disc_acc) with two variations. One is a dummy of absolute discretionary accruals (disc_acc_dum) with a value derived by splitting the sample from the median value of absolute discretionary accruals measured as '1' for greater than equal to (>=)and as '0' for less than (<) median of absolute discretionary accruals. This

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S.No	Variable	Definition
1	Size of the Board	Number of directors on the Board at the end of financial year
2	No. of Independent Directors	Number of independent directors on the Board at the end of financial year
3	% of Independent Directors	No. of Independent Directors/Size of the Board
4	Avg. No. of Board Meetings Attended	Average number of board meetings attended during the year by all the directors, who are on the Board at the end of financial year
5	Max. No. of Board Meetings	Maximum number of board meetings attended by any director, who is on the Board at the end of financial year (Proxy for Total Number of Meetings)
6	% of Board Meetings Attended	Avg. No. of Board Meetings Attended/Max. No. of Board Meetings
7	Avg. no. of other Chairpersonships held	Average number of Chairpersonships held in other companies by all the directors,who are on the Board at the end of financial year
8	Avg. no. of other Directorships held	Average number of Directorships held in other companies by all the directors, who are on the Board at the end of financial year
9	CEO_Chair	1 if Chief Executive Officer of the firm is also Chairperson of the Board of at the end financial year, else 0
10	Promoters ¶ Shares held	% shares held by promoters
11	Indian Promoters ¶ Shares held	% shares held by domestic promoters e 0 n

Results and Analyses

Descriptives statistics for the variables used in the study are given in the table below. The mean and median statistics for discretionary accruals proxy reveal both income increasing and income decreasing earnings management in the sample firms, which is taken care of by absolute discretionary accruals showing a mean value of 0.16 and a range of 2.72. On an average sample firms have 11 directors on board (size), with 50% of them being independent (ind), with a median average of 11 directors. On an average 74% of board meeting were attended by the directors (att). Promoter shareholding (pro_sh) median value of 53% shows the contextual concentrated ownership issue being a determining factor for examining the association with regard to the nature of promoters' shareholding being primarily indian or foreign and its impact on the associaton between earnings management and corporate governance attributes for family firms. Institutional shareholding –domestic and foreign in sample firms show an average 32.83%. Audit quality proxied by the presence of one of the big three auditors is measured as a (0,1) dummy variable showing that roughly 50% (55%) of the sample firms engage the services of the big three (Big Four) audit firms as their auditors, implying thereby that not all big firms in India (in the sample chosen – BSE 200 firms) engage the big three auditors. Standard deviations for most of the corporate governance attributes are low, signaling probably a kind of standardized adherence to similar norms of good corporate governance among firms in India. Family firm, our main independent variable shows that on an average about 26% of the board positions are held by family members in the sample companies (with minimum two members in the board being family members).

Descriptives Table

Quartiles Analyzed

Firm size has been an important influencing variable in literature (Becker et al., 1998), thus we use firm size measured as average total assets and segregate the sample into quartiles. We analyzed the means of all the variables within these quartiles with the smallest firm being in Quartile 1 and the biggest ones in Quartile 4. The general observation was that the bigger firms tend to manage their earnings upwards due to targets to be met in terms of market expectations (tacc_abs - Rs 5870 crores), while the smaller firms manage their earnings downwards to create a buffer for the next year (tacc_abs - Rs 378 crores). Firms with higher discretionary accruals (.04) were smaller in size, while those with higher assets size had smaller discretionary accruals (-0.01). Big firms would have larger analysts following and benchmarks to be achieved while smaller firms would have lower external expectations. Thus variables like board size, Indian promoter shareholding and institutional shareholding (domestic) are increasing with firm size; while absolute discretionary accruals are higher for smaller firms implying that income decreasing earnings management is more popular among smaller firms in India.

Table 2 Quartlies

avgta	avgta	size	ind	ind_num	meet_num	meet_max	att	chp	dir	ceo_chair	pro_sh	indpro_sh
1	11622.76	9.81	0.41	4.11	4.46	6.41	0.71	0.06	4.43	0.01	56.71	39.67
2	31034.05	10.59	0.48	5.02	4.42	6.03	0.74	0.11	4.92	0.04	50.44	39.44
3	73314.39	11.11	0.48	5.25	4.80	6.39	0.76	0.18	5.25	0.00	52.74	40.93
4	373532.80	12.45	0.44	5.39	6.18	8.36	0.75	0.13	4.53	0.00	57.20	49.72
Mean	122376.00	10.99	0.45	4.94	4.97	6.80	0.74	0.12	4.78	0.01	54.24	42.49

avgta_dum	forpro_sh	forpro_num	inst	inst_for	inst_dom	forinstpro_num	bigthree	bigfour	block5_sh	block5_num	block10_sh	block10_num
1	15.39	0.43	25.45	13.58	11.87	0.97	0.53	0.56	8.46	1.07	1.75	0.11
2	10.13	0.33	30.40	15.54	14.86	0.99	0.53	0.57	8.17	0.99	2.88	0.23
3	11.16	0.31	32.64	15.54	17.10	0.97	0.56	0.61	9.19	0.95	3.34	0.23
4	7.14	0.26	42.43	12.09	30.34	0.98	0.39	0.45	11.53	1.01	5.63	0.36
Mean	10.88	0.33	32.85	14.20	18.66	0.98	0.50	0.55	9.35	1.00	3.43	0.24

avgta_dum	tacc_abs	tacc_rel	nondis_acc	disc_acc	abs_da	ff	ff_cum
1	377.99	0.03	-0.01	0.04	0.23	0.28	0.25
2	877.12	0.03	0.02	0.01	0.19	0.31	0.32
3	2443.70	0.03	0.01	0.03	0.14	0.26	0.17
4	5869.99	0.01	0.03	-0.01	0.10	0.1844257	0.09829
Mean	2392.2	0.0256624	0.0115652	0.014256	0.1616205	0.258535	0.20833

The Regression Model

We examine the association between family firms and earings management proxied by discretionary accruals by estimating the following pooled OLS regession for each of the three variations of the dependent variable, being absolute discretionary accruals (abs_da), a dummy variable for absolute discretionary accruals (abs_da_dummy) and natural logarithm for the absolute discretionary accruals proxy (lnabs_da). We have controlled for firm size and the corporate governance variables of the sample firms.

$$disc\_acc_{it} = {}_0 + {}_1ff_{it} + {}_2ff\_dum_{it} + {}_3lnavgta_{it} + {}_4size_{it} + {}_5ind_{it} + {}_6meet\_max_{it} + {}_7att_{it} + {}_8pro\_sh_{it} + {}_9forpro\_sh_{it} + {}_{10}inst_{it} + {}_{11}forinstpro\_num_{it} + {}_{12}block10\_num_{it} + {}_{13}bigthree_{it} + {}_0 \quad (1)$$

$$abs\_disc\_acc_{it} = {}_0 + {}_1ff_{it} + {}_2ff\_dum_{it}$$

divided into deciles of about 200 firms each. We dropped firms where we had no market capitalization data available. The 5th decile of 204 firms, with market capitalization ranging between Rs 475 million to Rs 800 million was selected for further analysis. This method of sampling helps to capture a sample of mid cap firms with higher concentration of family firms.

We followed the same procedure for identifying the family firms out of these 204 firms with six years (2006-2012) of data. We had about 1078 firm year observations with about 770 family firm observations.

We started with the Difference of means t test for the corporate governance variable for these 1078 firm year observations to explore how these variables were different for the family firms as compared to the non family firms in the sample. Most of the important corporate governance variables were significantly different for the family firms in the sample.

t-test Results

Corporate Governance Characteristics					
Variable	ff = 0	ff = 1	Diff (High r Low)	t_value	p_value
board_size	7.2583	7.7161	-0.4578	-2.88	***
ind	0.4957	0.4752	0.0205	1.29	*
meet_max	6.0849	6.7699	-0.685	-**	

promoter shareholding and greater number of blockholders holding greater than 10% shares. Family firms in the sample have lesser percentage of independent directors and relatively lesser number of family firms gets audited by Big Four auditors as compared to the non family firms in the sample. Thus other than the proportion of independent directors and audit by Big Four, all the corporate governance variables indicate better governance indicator for family firms. This supports the existing literature discussing the need for family firms to opt for better corporate governance attributes as a mechanism for building family and business reputation

Descriptives statistics for the variables used in the new sample are given in the table below. Again we find both income increasing and decreasing earnings management in the sample and range for the earings management proxies is quite considerable. On an average sample firms have 7 directors on board, with 48% of them being independent (ind), with a median average of 8 directors. On an average 75% of board meeting were attended by the directors (att). Family

Descriptives Table

Descriptive Statistics								
Variable	N	Minimum	Lower Quartile	Mean	Median	Upper Quartile	Maximum	Std Dev
disc_acc	681	-0.0951	-0.0243	0.0006	-0.0093	0.0137	0.3521	0.0432
abs_disc_acc	681	0.0000	0.0105	0.0282	0.0209	0.0350	0.3521	0.0328
disc_acc_dum	770	0.0000	0.0000	0.3403	0.0000	1.0000	1.0000	0.4741
ff	770	0.0000	0.0000	0.6143	1.0000	1.0000	1.0000	0.4871
size	758	2.4159	6.4767	7.0751	7.0525	7.6950	10.1983	1.0948
roa	753	-0.8906	0.0419	0.0910	0.0856	0.1356	1.0555	0.1259
debt_asset	617	0.0000	0.0829	0.2057	0.1740	0.3007	0.9833	0.1595
inst	718	0.0000	0.0100	4.4326	0.3600	4.2400	89.5200	10.5749
ind	736	0.0000	0.4300	0.4827	0.5000	0.6000	1.0000	0.1943
age	758	3.0000	16.0000	25.5765	21.0000	31.0000	78.0000	15.1513
loss	763	0.0000	0.0000	0.1415	0.0000	0.0000	1.0000	0.3488
bod_size	736	2.0000	6.0000	7.5476	8.0000	9.0000	14.0000	2.0873
meet_max	736	0.0000	5.0000	6.5177	6.0000	8.0000	24.0000	3.3870
att	699	0.3300	0.6500	0.7456	0.7500	0.8400	1.0000	0.1447
bigfour	726	0.0000	0.0000	0.1074	0.0000	0.0000	1.0000	0.3099
forinstpro_num	718	0.0000	0.0000	0.3162	0.0000	1.0000	1.0000	0.4653
block10_num	153	1.0000	1.0000	1.2288	1.0000	1.0000	4.0000	0.5560

Correlations

The correlation table shows that we have significant negative correlation between signed accruals and the family firm variable (ff), but none between absolute accruals and ff. The same also reflects in the regression results shown later and indicates that family firms have lower discretionary accruals but more importantly, they indulge in downward earnings management as is evident form the difference in signs for signed versus absolute discretionary accruals. We also

Correlation table

Variables	disc_acc	abs_disc_acc	disc_acc_dum	ff	size	roa	debt_asset	inst	ind	age	loss	bod_size	meet_max	att	bigfour	forinstpro_num	block10_num
disc_acc	1	-0.06813*	0.8427***	-0.12149***	-0.03578	0.05386	-0.04105	0.03223	-0.02481	-0.11978	0.05849	-0.08017	0.05609	0.01748	0.02839	0.053	0.01335
abs_disc_acc	-0.06813*	1	0.10661***	0.02621	-0.12442**	-0.04188	-0.01753	-0.07434	-0.00988	-0.06847*	0.12278***	-0.05375	0.04463	-0.01465	-0.02647	-0.07308*	0.03845
disc_acc_dum	0.8427***	0.10661***	1	-0.1292***	0.01506	-0.02369	-0.00844	0.00527	0.03583	-0.0585	0.08642**	-0.01775	0.03109	0.00337	-0.01244	-0.00421	0.02928
ff	-0.12149***	0.02621	-0.1292***	1	0.09658***	0.055	0.15774***	0.01361	-0.08189**	-0.03222	-0.03723	0.09563***	0.05974	0.07585**	-0.06241*	0.05171	0.11136
size	-0.03578	-0.12442**	0.01506	0.09658***	1	-0.19404***	0.32946***	0.393***	0.2543***	0.07766**	0.01669	0.21214***	0.17399***	0.0102	0.07168*	0.25138***	0.02778
roa	0.05386	-0.04188	-0.02369	0.055	-												

The following regression equations were run for all the three proxies of discretionary accruals for our sample of family firms.

$$disc\_acc_{it} = \beta_0 + \beta_1 ff_{it} + \beta_2 firm\ size_{it} + \beta_3 roa_{it} + \beta_4 debt\_asset_{it} + \beta_5 inst_{it} + \beta_6 ind_{it} + \beta_7 age_{it} + \beta_8 loss_{it} + \varepsilon_{it} \quad (1)$$

$$abs\_disc\_acc_{it} = \beta_0 + \beta_1 ff_{it} + \beta_2 firm\ size_{it} + \beta_3 roa_{it} + \beta_4 debt\_asset_{it} + \beta_5 inst_{it} + \beta_6 ind_{it} + \beta_7 age_{it} + \beta_8 loss_{it} + \varepsilon_{it} \quad (2)$$

$$disc\_acc\_dum_{it} = \beta_0 + \beta_1 ff_{it} + \beta_2 firm\ size_{it} + \beta_3 roa_{it} + \beta_4 debt\_asset_{it} + \beta_5 inst_{it} + \beta_6 ind_{it} + \beta_7 age_{it} + \beta_8 loss_{it} + \varepsilon_{it} \quad (3)$$

We got the best results for discretionary accruals proxy. The difference in means t tests shows the corporate governance variables which are significantly different for the family firms in the sample. Thus we have not included all the corporate governance variables in the regression model. We have run the regressions on the model similar to the one used in Wang (2006).

The results support both our alternate hypotheses about family firms engaging in negative earnings management and having better corporate governance characteristics as compared to the non family firms in the chosen Indian sample firms. We can extend the theoretical argument laid

associated with discretionary accruals implying, a loss in the previous period increases the incidence of upwards earnings management to cover up for the loss and reflect better results for the firm. Higher return on assets (roa) is again positively associated reflecting higher discretionary accruals. This however could imply either increase in roa through managing earnings or better accrual

Regression results Table 2 Dependent Variable is Absolute value of Discretionary Accruals (abs_disc_acc)

Dependent variable: abs_disc_acc			
Variable	Coefficient	t value	Std. Error

Summary and Conclusions

Indian corporate sector with a predominance of family firms has to largely share the legacy of the common perception that results corroborated for some of the

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