Chapter 3

Owner Managers, Family Business, and Earnings Management Preceding Management Buyouts

Lokman Tutuncu
https://orcid.org/0000-0002-8653-9546
Bulent Ecevit University, Turkey

ABSTRACT

This study investigates earnings management prior to management buyouts in a sample of 269 UK private family and non-family firms. It hypothesizes that concentrated ownership in private non-family firms provides sufficient wealth incentives and power to owner/managers to manage earnings upwards before the acquisition, while family owners use management buyouts as a succession tool in the absence of a suitable family successor out of concern for the future of family business. The results are consistent with this prediction. Owner/managers in non-family firms tend to overstate earnings preceding the buyout while family ownership is negatively associated with discretionary accruals one year before the buyout transaction.

INTRODUCTION

Prior research investigates earnings management (EM) in listed family firms (Wang, 2006; Prencipe, Markarian, & Pozza, 2008; Tong, 2007; Achleitner, Gunther, Kaserer, & Siciliano, 2014), private family businesses (Stockmans, Lybaert, & Voordeckers, 2010), and going private buyouts (Perry & Williams, 1994; Mao & Renneboog, 2015). This study examines EM preceding management buyouts (MBO) of private firms. Private firms constitute majority of MBO acquisitions worldwide (Strömberg, 2008) and family firms are an important source for these deals (Howorth, Westhead, & Wright, 2004; Scholes, Westhead, & Burrows, 2008). The research on the non-listed family and non-family firms is scarce due to difficulty in obtaining private firm data (Prencipe, Bar-Yosef, & Dekker, 2014; Paiva, Lourenco, &

DOI: 10.4018/978-1-7998-7596-3.ch003

Branco, 2016). This study pays special attention to private family and non-family owned firms, whose managers, in the MBO context, have varying motivations to engage in or refrain from earnings management. Analysis of EM behaviour in family and non-family private firm acquisitions provides an ideal setting to observe managerial deviations from fiduciary duties and moral hazard problems pointed in the prior research.

Existing family studies examine financial reporting in a conventional setting that lack the unique managerial incentives and agency conflicts induced by the initiation of the acquisition process. The underlying moral hazard in MBOs involves incumbent managers of listed firms expropriating shareholders by exploiting their decision-making powers and dispersed ownership structure of the firm (Perry & Williams, 1994). The manager-owner relation is; however, more complicated as far as private firms are concerned, which characteristically have concentrated ownership and as a consequence, blurred owner/manager responsibilities. More importantly, the selling owner/managers or family members often possess control powers to manipulate earnings upwards to the detriment of the acquiring team. This contrasts with public firms, where managers tend to possess opportunistic incentives to understate earnings for the benefit of the acquiring investors of which they are part. An examination of private MBO acquisitions, therefore, provides an opportunity to shed light on an important but unanswered question: whether/why private firms in general, and private family firms in particular, engage in earnings management prior to a major event associated with their wealth. For many private firms, financial statements are the only source of public information. A better understanding of the quality of this information is important for investors, creditors, and regulators.

The entrepreneurship literature highlights the need for more studies on agency conflicts during private family firm successions (Howorth et al., 2004; Scholes et al., 2008), especially those that compare EM practice in family and non-family firms (Salvato & Moores, 2010). Past studies do not make any distinction between private family and non-family owned businesses (Burgstahler, Hail, & Leuz, 2006), and future contributions would come in the form of comparative studies in this field (Paiva et al., 2016). Although private family firms represent the majority of firms worldwide (IFERA, 2003), little is known about the family firms' accounting practices (Hutton, 2007; Salvato & Moores, 2010; Prencipe et al., 2014). This study attempts to fill a gap by comparatively investigating private family and non-family firms.

The study hypothesizes that owner/managers will have enhanced motives to inflate income before MBO due to their selling position in the deal, their large ownership stakes and the corresponding wealth considerations associated with the transaction. Family firms are, in contrast, predicted to be more concerned about their family identity and culture than their wealth to prevent EM prior to succession of the family business to managers. These two different private firm positions are tested by discretionary accruals models in a sample of 269 UK buyouts. As expected, private family owned firms show no evidence of EM and non-family firms report significant income-increasing EM one year before the acquisition. Regressions of family dummy and ownership on the discretionary accruals support the results. The results underline positive impact of family succession on wealth motivated moral hazard, while cautioning against extrapolating the results from exclusively listed firms to the overall population of MBOs.

This chapter makes two contributions to the existing literature. First, it contributes to the family business literature by presenting the first analysis of EM related to a major corporate event which coincides with or leads to family succession and where event-specific incentives to engage in EM are present (i.e., acquisition via buyout). Second, it adds to the literature by providing the first comparative analysis of EM in non-listed firms and showing that owner/managers inflate earnings in the absence of family cul-