Chapter 18

Earnings Management and Corporate Governance in Family Firms:
Evidence From a Small Market

Elisabete Vieira
ISCA-UA, Portugal

Mara Madaleno
GOVCOPP Unit Research, Portugal

ABSTRACT

Earnings management and corporate governance relationships are examined for a sample of 49 Portuguese listed firms considering an unbalanced panel for the period 2002-2017, using panel corrected standard errors models and considering the family ownership effect. Empirical findings reveal that there is a positive relationship between corporate board independence and earnings management and that the presence of women on board decreases earnings management practices. Results are consistent with the hypothesis that earnings management practices are lower in family firms than in non-family firms. Size, being audited by the Big 4 companies, return on assets, loss, and the existence of an audit committee on board influence positively earnings management, but leverage, age, and ownership control are negatively related to earnings management. Results indicate that further auditing and control is necessary for Portuguese listed companies leading to strict recommendations to be followed by policymakers regarding control of these firms.

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INTRODUCTION

The main objective of this study is to investigate the relationship between earnings management and corporate governance, since it is a new direction in research about earnings management. We intend to analyze this relationship in the context of family firms, to see their motivation to implement earnings management practices. Furthermore, we will analyze whether family firms differ from their counterparts in what concerns the association between earnings management practices and corporate governance.

Previous literature document that firms with independent boards are more likely to have less earnings management (Dechow & Dichev, 2002). Jaggi, Leung, and Gul (2009), using a sample of Hong Kong firms, document that corporate board independence is important to ensure high-quality financial reporting. In spite of the studies that document earnings management, there are other studies finding no evidence of significant earnings management practices, such as Ball and Shivakumar (2005), in the UK. Although there are some studies analyzing the relationship between corporate governance and earnings management in these two countries, it is a scarce topic studied in other countries. Consequently, we would like to study this relationship in the Portuguese market. As far as we know, no other study attempt to study this relationship in Portugal.

We extend the existing research on the relationship between earnings management and corporate governance in several ways. First, Portugal is a country of interest because it differs from the main studied markets in some features, such as the USA and the UK, namely because it has a weak legal protection for shareholders (La Porta, Lopez-de-Silanes, & Shleifer, 1999; Setia-Atmaja, Tanewsky, & Skully, 2009), it has a high level of ownership concentration, and it is influenced by the civil law. This characteristics can cause differences among countries, namely with regard to corporate governance, ownership and control (Jaggi et al., 2009). Thus, the results may differ from the ones obtained in countries where outside investors are well protected by the legal system, the level of transparency is high and the equity ownership is relatively dispersed (González & García-Meca, 2014). Some studies indicate that the institutional arrangements of a country have a significant impact on the earnings management practices and, consequently, on earnings quality. Leuz, Nanda, and Wysocki (2003) find higher earnings management in countries with lower investor protection and with undeveloped capital markets, and Ball, Robin, and Wu (2003) maintain that institutional factors have a significant influence on the managerial incentives for financial reporting[1].

Second, we investigate the specific case of family firms, and, indeed, a significant number of family businesses characterizes Portugal. Family businesses are usual among listed firms around the world (La Porta et al., 1999; Anderson & Reeb, 2003; Prencipe, Bar-Yosef, & Dekker, 2014). Specifically, Faccio and Lang (2002) document that 60.34% of Portuguese firms are family businesses. Portuguese family firms (FF) are mainly small and medium firms, with managers having low levels of training, and having problems of succession. Although their relevant contribution to the employment (about 60%) and to the Gross Domestic Product (around 50%), studies on Portuguese family businesses are very rare, so, we think this type of firms is in need of research.

In what concerns studies about earnings management practices and family firms, some authors document that family ownership concentration influences earnings quality, such as Anderson and Reeb (2004), Ali, Chen, and Radhakrishnan (2007), and Siregar and Utama (2008). Hence, the issue of the impact of corporate governance on earnings management in family firms in an environment of weaker investor protection merits empirical investigation.

Related Content