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Family Ties: Impact of Socioemotional Wealth and Succession on Real Earnings Management

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Abstract

Private family businesses make up a significant portion of the world economy. While contributing to the larger macro environment, they also contribute critical resources to their communities and family units. Earnings management is a practice that is detrimental to future business viability. The motivation to use earnings management is different in family businesses as they have unique pressures and characteristics. Socioemotional wealth includes non-financial incentives exclusive to family businesses and is predicted to influence earnings management behavior. Succession is an event that is critical to all businesses, however, the pressure for generational transfer in family businesses can be greater due to resource retention that requires familial succession. The motivation to manipulate financial signals is potentially stronger when the company is executing a generational transfer and needs to display financial strength. This study finds that socioemotional wealth and succession impact real earnings management behavior in family firms. When succession is not present, the study finds that companies with high socioemotional wealth are less likely to engage in real earnings management. However, when succession is present, companies with high socioemotional wealth engage in real earnings management at a significantly higher rate than low socioemotional wealth businesses. The study's experimental design using participants involved in a family business, offers a unique opportunity to better understand this critical portion of the economy and the characteristics and events that potentially impact real earnings management decisions in family businesses.

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Private family businesses make up a significant portion of the world economy. While contributing to the larger macro environment, they also contribute critical resources to their communities and family units. Earnings management is a practice that is detrimental to future business viability. The motivation to use earnings management is different in family businesses as they have unique pressures and characteristics. Socioemotional wealth includes non-financial incentives exclusive to family businesses and is predicted to influence earnings management behavior. Succession is an event that is critical to all businesses, however, the pressure for generational transfer in *family* businesses can be greater due to resource retention that requires familial succession. The motivation to manipulate financial signals is potentially stronger when the company is executing a generational transfer and needs to display financial strength. This study finds that socioemotional wealth and succession impact real earnings management behavior in family firms. When succession is not present, the study finds that companies with high socioemotional wealth are less likely to engage in real earnings management. However, when succession is present, companies with high socioemotional wealth engage in real earnings management at a significantly higher rate than low socioemotional wealth businesses. The study's experimental design using participants involved in a family business, offers a unique opportunity to better understand this critical portion of the

economy and the characteristics and events that potentially impact real earnings management decisions in family businesses.

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Chapter One

Introduction

Family businesses are an important part of any economy. In the United States (US), more than 50% of the Gross Domestic Product (GDP) and nearly 60% of the workforce is attributed to family businesses (*Family Enterprise USA: Focus*, 2021). In 2020, the US GDP was $20.94 trillion, and total employment was nearly 161 million; therefore, more than 96 million US employees and $10.5 trillion of the US GDP can potentially be credited to family businesses.

In addition to the overall economic contribution, these businesses contribute to their core family units and communities. Family members receive financial resources, emotional support, career opportunities, entrepreneurial funding, and identity. Communities rely on these businesses not only to provide goods and services but also to be "an employer, a standard bearer, and a community hub, just to name a few" (Angus, 2020). Therefore, understanding more about the factors that impact the future sustainability of these important players in our economy is imperative.

Financial heath is a vital precursor to the long-term success of all businesses. However, the use of earnings management is widespread. Earnings management is considered "the act of intentionally influencing the process of financial reporting to obtain some private gain" (Rjonesx, 2022). Graham et al., (2005) finds that a staggering 78% of the 400 Chief Financial Officers interviewed for their study admit to

"sacrificing long-term value to smooth earnings" (p. 4). [1] While earnings management is not considered illegal or in conflict with generally accepted accounting principles (GAAP), it is something that interested users of financial information should be aware of as the research suggests that real earnings management (REM) is generally bad for the long-term health of a firm.

Research is emerging that finds REM, when used in certain situations, can have a positive impact on future earnings if not used for "managerial rent extraction" but rather to "just meet benchmarks" (Gunny, 2010, p. 857). However, most of the research suggests that REM is a precursor to a business's suboptimal financial performance or erosion of value (Jensen, 2005; Tabassum et al., 2015; Leggett et al., 2011; Darmawan et al., 2019). The conflicting findings suggest that there is a potential difference in REM impact based on the level and motivation of REM. However, most research continues to suggest that businesses should be cautious about the use of REM as it appears to, more frequently, have a detrimental impact on the financial well-being of an organization. Using the belief that REM is not a desired action for a family business, this study attempts to understand the likelihood of engaging in REM from two perspectives: socioemotional wealth and succession.

Family businesses are inherently different than non-family businesses with varying motivations that extend to decision making at all levels of the organization (Berrone et al., 2012). While all organizations have the core duty of creating net income or

[1] The CFOs interviewed were from both public and private companies but no specification about family or non-family status was provided.

shareholder value, family businesses have an additional layer of wealth that is not financial. These unique family business characteristics have been referred to in the literature as Socioemotional Wealth (SEW), which often includes family reputation, familial relationships, legacy, and community involvement (Gómez-Mejía et al., 2007). SEW motivations can alter REM behavior as SEW represents "non-financial benefits that extend from the family's vision for the business and how such benefits are expected to contribute to the well-being of the family" (Debicki et al., 2016, p.47). There can be a significant desire in family businesses to preserve reputation, create generational sustainability, sustain familial connection, create a legacy, and produce future opportunities for heirs.

Research suggests that SEW alters the actions of the business, specifically of upper management (Gomez-Mejia et al., 2011). The charge to create and maintain financial wealth is sometimes in conflict with a family's desire to create and maintain SEW. This additional dynamic of familial relationship and reputation preservation can often create additional motivation for a financial officer to manage (or not manage) earnings (Achleitner et al., 2014). While the motivation might be benign, the ramifications can be detrimental to future financial performance.

Ward's infamous 1987 study cites that 70% of family businesses will fail to transfer through the second generation, and an astonishingly high 90% will fail through the third. The number of family businesses nearing a generational transfer decision is overwhelming. According to the US Census (2019), approximately 33% of all US

businesses have been in business more than 15 years and another 14% are approaching that benchmark within the next five years, likely approaching a succession decision.

While succession is important to all businesses, there are additional pressures on families to make the transfer successfully. This pressure likely impacts decision making during the succession period. With succession struggles well documented in the research (Handler, 1994; De Massis et al., 2012; Lansberg, 1988; Robert, 2004), it is important to understand how succession might impact real earnings management in family businesses.

Succession failure can come from many sources: lack of planning (Sharma et al., 2003), complex family relationships (Lansberg & Astrachan, 1994), the business environment (De Massis et al., 2008), and successor identification issues (Longenecker & Schoen, 1978). However, one consistent theme throughout the succession literature is that financial health is an important factor in successful generational transfer (De Massis et al., 2012; Barach & Ganitsky, 1995). The long-term financial health of a business can be damaged through earnings management (Jensen, 2005) but the use of earnings management may be more prevalant when the business is in succession in an attempt to smooth the immediate transition. Although REM behavior potentially creates long-term problems for family businesses, we do not have a good understanding of earnings management in these businesses and the impact that succession might have on the behavior.

Research Question

How do succession and socioemotional wealth impact the real earnings management behavior of small to medium US private family businesses?

Study Summary

I predict and find support that a higher level of SEW results in less REM behavior. Small and medium-sized family businesses have an overlap in management and ownership. Within that population, high SEW businesses are likely to have a greater overlap as there is a desire for familial control of the entity that leads to stronger control mechanisms, such as day-to-day management of the business. The aversion to REM is thought to be stronger in high SEW family businesses as the desire to maintain non-financial metrics such as reputation, community standing, familial relationships, family prominence, family continuity, and family enrichment establish an alignment of interests and create a shared vision to be proper stewards of the business and maximize its long-term value. The lack of information asymmetry and conflict of interests, combined with the desire to maintain SEW, will reduce real earnings management behavior in high SEW companies. These interests are different in low SEW family businesses who are likely to have a more dispersed control structure, where managing owners have access to more information than non-managing owners. In these businesses there is the potential to have a more egocentric view on actions that the business should take, putting themselves ahead of the overall business.

I also predict and find support that when succession enters the equation, behaviors change. High SEW families become more willing to manage earnings than their low SEW counterparts. The agency problems avoided for high SEW companies when succession was not present now become more relevant, as succession, by its very nature, separates current managing owners from managerial control. The transferring generation

possibly has access to more complete information, and their interests might no longer be perfectly aligned with the successive generation. Current managing owners could use the succession period to make decisions that are not considered optimal for the long-term value of the business.

For low SEW companies, agency theory shifts as well. The majority owner(s) becomes the party with less than complete information and their interests become more focused on the long-term, moving to a stewardship perspective of the business. A low SEW family is less concerned with non-financial goals and will not sacrifice long-term business value to ensure succession victory or retain SEW elements using REM.

The pressure for generational transfer is likely higher for high SEW companies and creates additional incentives to employ REM. Financial signals sent by the current managing owner need to entice the successor generation, maintain vendor relationships, and acquire short-term funding. These signals need to convey maximum financial strength of the company to aid in succession and the pressures to signal health will overcome stewardship of the business, creating incentive to manage earnings. Information asymmetry, conflict of interests, and the desire to manipulate the financial signals during the succession period will increase the occurrence of REM in high SEW family businesses.

The study tests the hypotheses with an experiment. All participants are family member owner/operators of a small to medium private US family business. SEW is a measured continuous independent variable and succession is a manipulated independent variable. The level of SEW for each participant's business is measured using the SEWi

scale created by Debicki et al. (2016). Half of the participants receive information that the business is in a phase of active succession, while the other half of the experimental group is notified that succession is not imminent.

Data is collected through the presentation of a case involving an opportunity to use REM in the participants' family business under a fictitious scenario. Participants receive three years of financial data (income statement and balance sheet). They are then presented with an opportunity to decrease or cut advertising to avoid a debt covenant violation that triggers an increased interest rate, notification to other owners, and prevents them from participating in a high-profile community event. The dependent variable of interest is the REM decision. It is a binary variable of either yes, the participant chooses to manage earnings, or no, they do not. The binary REM dependent variable is a well-used tactic and easy to understand for participants.

The experiment finds support for the predictions. While support is found for the main effect of SEW on REM, showing lower levels of REM as SEW increased, the interaction effect of SEW and succession supersedes these findings. It finds that high SEW companies are more likely to use REM, but only when succession is present. It finds support that this propensity to use REM reverses when the company is amid an active succession to the next generation of ownership and high SEW companies are more likely to use REM than low SEW companies.

Contributions

This study makes several contributions to the literature on earnings management in family firms. The focus in the current earnings management literature is on the

differences between family and non-family businesses (Gómez-Mejía et al., 2007; Martin et al., 2016; Jiraporn & DaDalt, 2009; Gavana et al., 2017; Borralho et al., 2020; Gavana et al., 2017). While this offers interesting insight into the relative behavior, it stops short of identifying factors that are specific to family businesses and the magnitude and variations of any effect *among* family businesses. This study brings clarity to US family businesses and how SEW and succession impact the motivation and behavior around REM.

Many other studies attempt to understand earnings management behavior in family businesses by analyzing non-US businesses (Borralho et al., 2020; Razzaque et al., 2016; Stockmans et al., 2010; Yang, 2010; Achleitner et al., 2014; Jara-Bertin & Sepulveda, 2016; Ferramosca & Allegrini, 2018). Cultural dynamics vary from country to country and that potentially creates a difference in the behavior of US family businesses versus non-US family businesses, specifically when evaluating earnings management behavior. In addition to varying culture and behavior, information for US family businesses is not as readily available as information on non-US family businesses, leading to fewer studies focused on the US family business population. This is often a result of status, regulation, and cultural willingness to share information. The difficulty in obtaining US-based information should not diminish our intellectual curiosity related to the behaviors of US family businesses.

Diving deeper into the US family business research reveals a gap in the study of small to medium US enterprises (SME). Without a requirement for public reporting, the information is scarce at best. However, the proportion of these businesses in the US is

high and creates a greater need for research in this area. This study offers insight into how SEW and succession in family businesses might impact the use of REM, allowing business owners an opportunity to steer away from or have heightened awareness of these factors to preserve the family business.

The study also offers an empirical test of the SEWi scale developed by Debicki et al., (2016). SEW is difficult to operationalize and empirical experimental research adds to the body of knowledge that supports the measurement and use of this construct. In addition, this study measures actual owner/operators of family businesses and their associated levels of SEW using the accepted scale.

Getting inside the black box of succession is a monumental task. This study attempts to determine how succession impacts behavior in family businesses. The study provides support that succession influences decision making and, in certain situations, can ultimately harm the business. If owners are made aware that motivations (and related actions) can be materially influenced when succession exists, they can actively work to overcome them or put controls in place to monitor and prevent them from occurring.

There is considerable discrepancy between research on the effect of SEW on REM, some suggest a positive effect and some a negative effect. This study offers a potential source of the tension. This study finds that SEW does not impact REM without succession and few of the current research studies review these concepts in tandem. This study offers insight into the complex motives and relationships that exist in family businesses.

Finally, in practice, understanding how to position a family business for succession realization is important. We do not know exactly what factors impact the failure rate, but identifying how facets of the businesses (SEW and succession) might impact REM and ultimately financial performance will be important to small and medium-sized family business owners in the US as they begin their succession journey.

Dissertation Organization

The remainder of this dissertation includes a review of relevant definitions and literature in accounting and family business research in Chapter 2. This includes a review of REM, agency theory, signaling theory, SEW, and succession. Chapter 3 includes the detailed methodology used to test the hypothesis presented in Chapter 2 with Chapter 4 presenting the study results. The dissertation concludes with Chapter 5, a discussion of the findings and outline of the limitations of the study and areas for future research.

Chapter Two

Study Definitions

Family Business

At the core of all family business research is the ever-elusive definition of a family business. There is much discrepancy in the current research regarding what qualifies a business as a family business. The main threads of definition revolve around ownership management, family involvement, and generational transfer (Handler, 1989). Some researchers use more than one of these dimensions to further refine the definition (Shanker & Astrachan, 1996; Ferramosca et al., 2018).

Astrachan and Shanker (2003) provide a well-cited evaluation of the criteria necessary to qualify a business as a family business using multiple dimensions. They use a "bull's-eye" approach allowing for a broad definition and then moving to a much tighter and explicit definition (p. 212). The outer circle (the most inclusive) of Astrachan and Shanker's definition requires only that there be some family control of the strategic direction and some level of family participation in the business. The next circle adds the criteria of the founder (or their descendent) running the business and an intention to keep the business in the family. Finally, the innermost circle restricts the pool even further by requiring the business to be currently run by multiple generations and have more than one member of the family with management responsibilities (p. 218). Pieper et al. (2021) estimates that the "outer ring contains 32.4 million family businesses, representing 87%

of all business tax returns in the United States…the middle ring, 9.1 million family businesses, accounting for 25% of business tax returns…the narrowest ring, 7.2 million family businesses, totaling 19% of business tax returns" (p. 13).

A definitional distinction is important to fine-tune the research to the most appropriate audience. Family business behavior can vary dramatically as we navigate through the bull's-eye definition provided by Astrachan and Shanker (2003). The outer circle is likely too broad, as it includes many businesses that are sole proprietorships organized by a single individual with no employees or intention to continue beyond the life of the original founder. It also includes businesses that might have lingering family ownership, but no real control or intention to continue the familial characteristic. The innermost circle, the most stringent of the definitions, requires that multiple generations be involved in the business. While this is certainly an acceptable requirement for an enduring family business, a business that has yet to reach the life stage that allows for multi-generational control is excluded from the succession discussion when that business is likely the key audience.

The statistics provided by Family Enterprise USA (2021) and widely used in recent literature suggest that the middle ring of the bull's-eye is the most accepted definition. In addition, the middle section of the population appears to be the most applicable to this study as it includes only businesses interested in generational transfer. Therefore, this paper defines the family business as one that has strategic control by the family, a founder or descendent runs the business, and there is an intention to keep the business in the family indefinitely through generational transfer.

Using this definition of family businesses, we can begin to paint the picture of the dynamics within these companies that might be relevant to the theoretical application of REM. With high levels of control by the family, there is likely a high level of control over how to report the financial condition of the businesses, potentially exposing the business to more opportunities for REM (Paiva et al., 2016). However, it has also been found that family businesses tend to have a longer investment horizon, so they are less likely to participate in activities that would harm the continuity of the business (Stein, 1988).

Another conflicting dynamic is the lack of professionalism sometimes seen in a family business (Poutziouris, 2002). For example, many Chief Financial Officers in family businesses, might not possess the typical accounting and finance backgrounds seen in non-family businesses. However, that can be countered by a superior level of oversight due to the intimate knowledge that a family often has about the inner workings of the business (Paiva et al., 2016). The lack of professionalism might lead to a poor understanding of the impact of REM, but the heightened oversight might identify the behavior more quickly.

Finally, the non-financial goals (SEW) of a family business (familial relationships, legacy, succession, reputation, etc.,) can create motivation for earnings management while also acting as a deterrent. The familial dynamic potentially increases motivations for earnings management if one family member is attempting to "keep the peace" by smoothing earnings, but a desire to preserve the family reputation might deter the behavior. Family feuding with limited resolution within the business also exposes the

business to attempts by one family member to be less than transparent with financial and/or business information provided to another family member (Levinson, 1971).

Public vs. Private Business

US businesses that are publicly traded are highly regulated, with auditing and reporting requirements prescribed by the Securities and Exchange Commission (SEC). Private businesses do not have the same requirements and therefore have greater opportunities to participate in earnings management with decreased reporting and auditor scrutiny. Aside from regulatory requirements, the quality of accounting information is often derived "from the demand for such information for use in contractual arrangements and from the incentives and opportunities of management to manage the reported numbers" (Givoly et al., 2010, p. 196). The public or private structure of a company is likely to influence this behavior.

Studies attempt to test the differences between public and private businesses by studying private industries in the US that require some form of public reporting (banking and insurance) or private companies in the European Union where accounting regulations do not vary between public and private businesses (Bonacchi et al., 2019). While some studies support the notion that private businesses have higher information quality (Beatty et al., 2002; Givoly et al., 2010), others find information quality to be less in private businesses (Hope et al., 2013; Burgstahler et al., 2006). While resolving these differences is not the aim of this study, it is important to recognize the inherent differences between private and public businesses and their behavior (Fleming et al., 2016) as well as the lack of current information on private US businesses.

Small and Medium-Sized Businesses

According to the Office of the United States Trade Representative (2022), there are more than 30 million small and medium-sized enterprises in the US which "account for nearly two-thirds of net new private sector jobs." However, the majority of family business research focuses on their larger publicly held counterparts (Salvato & Moores, 2010). This is often attributed to the ease by which public data can be found and the desire to provide research for widely held businesses (Paiva et al., 2016).

Theoretical Background

Understanding the climate and characteristics of organizations where REM occurs centers primarily on information asymmetry, conflicts of interest, and opportunity. These concepts are most salient in two theories: agency and signaling.

Agency Theory

Understanding why a family business might manage earnings starts with agency theory. Agency theory outlines problems that stem from a situation where there is a need for an agent to act on behalf of a principal, and the parties do not have access to identical information. Jensen & Meckling (1976) define an agency relationship "as a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision-making authority to the agent" (p. 308).

For family businesses, agency problems exist because of the separation between ownership and day-to-day control of the business. This separation creates a conflict of interest between agent and principal; or manager and owner (Jensen & Meckling, 1976).

Family businesses often represent a large portion of a family's financial portfolio; therefore, the owner likely wants what is best for the overall company in the long-term. The manager's interests are more myopic and likely revolve around what is best for the manager (continued employment, personal wealth, experience, resume building, etc.). These competing interests can lead to less-than-optimal decision making by the manager at the expense of the company. To mitigate the risk from this conflict, owners can institute more oversight at the company level, diversify the risk with other investments, or tighten the gap between ownership and management by actively participating in the day-to-day operations of the company.

Current family business literature asserts that standard agency problems are diminished in small to medium family businesses because of high levels of familial control and participation; the agent and principal (manager and owner) are often either the same person or come from the same family (Tong, 2007). Consequently, information asymmetry is reduced, and the interests are more aligned, leading to less conflict and more optimal decision making in terms of business performance (Salvato & Moores, 2010). These dynamics might lead to decreased earnings management as demonstrated by Cascino et al. (2010); Achleitner et al. (2014); Borralho et al. (2020) and Jiraporn & DaDalt (2009).

Although small and medium family businesses might enjoy fewer problems arising from information asymmetry and conflicts of interest between employees and ownership, agency problems can also exist between managing and non-managing owners (Gilson & Gordon, 2003; Paiva et al., 2016; Ding et al., 2011). A managing owner with a high level

of day-to-day control can have the opportunity and motivation for non-optimal decision making (Charitou et al., 2016). When managing owners are in a position of power, they can make decisions that elevate their position at the expense of non-majority owners and take actions for their own benefit, not necessarily for the betterment of the business (Prencipe et al., 2014). This is a form of agency problem, as there is a separation between owner and manager. In this case it is a separation between managing owner and non-managing owner, and there is information asymmetry and potential conflicting interests in that relationship. For example, a managing owner who decides to increase the salary of a child beyond industry standards, benefiting the immediate family unit at the expense of the extended family unit and family business.

As family businesses become more tightly aligned with management and ownership from the same family, agency problems are likely to still exist among family members as the managing owner typically takes the lead in information aggregation and decision-making, the key ingredients for earnings management. If the managing owner sees benefit in using REM and has ample opportunity to execute it, higher levels of earnings management may be present within a family business.

Yang (2010) finds that family businesses with higher levels of insider ownership show higher levels of earnings management, indicating support for the occurrence of managing vs. non-managing agency problems in family businesses. The assertion that the conflict of interest between a managing and non-managing owner can lead to earnings management is also supported by Ding et al. (2011) and Chi et al. (2015) who find that

family businesses have higher levels of earnings management than non-family businesses.

Signaling Theory

The problems that arise from information asymmetry are also addressed by Spence (1973) with the introduction of the concept "market signaling." His seminal study models the new concept in the job market. The theory helps explain the behavior when two parties have access to different information and there is a desire to reduce information asymmetry. The signal sender must decide what information they want to share and how to share it. Then, the receiver must interpret the signal (Connelly et al., 2011). Education has long been used as an example of signaling. Students purchase an education from a prestigious university to signal their competency to potential employers; the signal is valid or false. The student could be a terrible student and was only admitted due to family connections, in which case, the sender (student) was able to deceive the receiver (employer). However, if the student is truly gifted and the employer interpreted their attendance at that university as a signal of their talent, the signal was valid.

Spence (1973) makes an important distinction between signals and indices, "reserving the term *signals* for those observable characteristics attached to the individual that are subject to manipulation by him" (p. 357). Financial information transmits information between parties to ensure that everyone is using the best information for decision making, eliminating information asymmetry. Now, let us consider a situation where the financial statements indicate a miss from expectations. In this situation, the owner might believe that the future is still bright for the company and its prospects are good; however, the

signal the financial statements will convey is less than positive. The owner could choose to use REM to manipulate the signal being sent so they can convey their true belief in the company, a much more positive outlook. The signal now reflects prospects not captured by standard financial statements and reduces information asymmetry.

The financial data shared by a company is consumed by many interested parties (other owners, employees, vendors, banks, community members); therefore, there are many reasons why a family business might want to manage earnings and adjust a signal being sent and received. There are risks and benefits of using REM to adjust the signal. The signal might allow the company to obtain better terms with a vendor or bank resulting in savings over the coming years. However, the continued use of REM to modify a signal could lead to sub-optimal performance as less than ideal business decisions accumulate over time (Jensen, 2005).

Recent studies have emerged supporting the assertion that there is a link between earnings management and signaling. Smith and Pennathur (2019) find that firms manage earnings to signal to the market their upcoming dividend policy and free cash flow. Gunny (2010) also notes that firms manage earnings to "signal future firm value" (p. 857). The prolific use of financial information as a signal gives plenty of motivation for those in power to alter that signal through earnings management to either benefit themselves or the business.

Earnings Management

The motivations to manage earnings are discussed in three categories: intrinsic, speculative, and pressure from related parties (Hashim et al., 2013). In addition, Achilles

et al. (2013) finds that extrinsic motivations such as competition and recognition also drive earnings management behavior. These motivations can often look like desires to stay in line (or ahead) of expectations, meet bank- required covenants, earn bonuses, hit internal targets, drive up stock prices, and more. There are many definitions, origins, and opinions about what constitutes earnings management and the true consequences of such action. Healy and Wahlen (1999) provide the following definition:

> Earnings management occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting practices. (p. 368)

There are two important deeper classifications for earnings management: accrual-based earnings management (ABEM) and REM.

Dechow and Skinner (2000) define ABEM as using choices that are GAAP compliant to "obscure" or "mask" true performance (p. 240) while REM is defined as "departures from normal operational practices, motivated by managers' desire to mislead at least some stakeholders into believing certain financial reporting goals have been met in the normal course of operations" (Roychowdhury, 2006, p. 337). The important similarity between these two forms of earnings management is that management *intends* to misrepresent true performance. However, in ABEM, there is a reporting mechanism used, while in REM, an actual business decision and related action are taken. An example of ABEM would be an adjustment in accounting estimates to increase or decrease earnings, such as reducing the useful lives of fixed assets to increase depreciation expense and decrease reported earnings. ABEM techniques are often considered less aggressive as they are ultimately timing choices that will smooth out over the life of the business.

REM is an intentional action that deviates from a real business decision considered to be the best practice. Executives might participate in REM to produce higher (profit maximization) or lower (tax avoidance) earnings in the short-term (Slide, 2021), for example increasing or decreasing investment in research and development or advertising, decreasing pricing to increase sales, or increasing production to lower cost of goods sold through the allocation of fixed costs. These actions alter the short-term reportable income but are potentially not beneficial business decisions and can harm the future financial health of the business. REM, while not fraudulent, can be more damaging as it entails the execution of real actions that are taken without the exclusive best interest of the business in mind. For example, reduction in R&D investment can potentially damage the business's future earnings or value. REM decisions often do not reverse or even out over the life of a business as ABEM can be expected to do.

The true cost of REM behavior is studied extensively, and many studies conclude that it has an adverse impact on the company and its future operations (Leggett, et al., 2011; Tabassum, et al., 2015). Jensen (2005) states his perception of REM quite clearly saying, "When managers smooth earnings to meet market projections, they are not creating value for the firm; they are both lying and making poor decisions that destroy value" (p. 8). In addition to future operational impact, Badertscher (2011) finds that the use of REM in companies often leads to the eventual use of fraudulent non-GAAP methods to mask the true economic performance of a company.

Although there are many studies that provide support that REM can erode company value, hamper future performance, and lead to illegal behavior; there are others that

minimize the costs of such behavior and purport that it is neutral and potentially beneficial to a company (Beatty & Harris, 1999). The beneficial characteristics of REM center primarily around its ability to modify the signal to an interested party to generate benefit for the company. Gunny (2010) notes "using RM to influence the output of the accounting system is not opportunistic, but consistent with managers attaining benefits that allow better future performance or signaling" (p. 855). It is important to note that Gunny (2010) finds a positive correlation between REM and future performance to be present in firms in a very particular situation, those that are "using operational discretion to just meet benchmarks." That same study confirms prior findings that "a negative association is consistent with managers using operational discretion to influence the output of the accounting system for managerial rent extraction" (Gunny, 2010, p. 857). Although the jury is still out on the true impact of REM on a firm's future performance, understanding when it is present and how it might impact the future for a family business remains important. This study makes the presumption that one should avoid REM as it is proven to reduce future firm value and financial health.

Hypothesis Development

Socioemotional Wealth

While agency theory supports the idea that there is motive (information asymmetry) and opportunity (acting on behalf of others) for earnings management in family firms, SEW theory suggests the unique characteristics of a family business will mute the pressures of REM. The longer-range focus for family businesses, coupled with a desire to pass along the business to future generations requires an additional perspective.

SEW is a concept borne from the family business research and is unique to this research domain. It was first presented by Gómez-Mejía et al. (2007) to reference the non-financial dynamics of a family business that ownership is interested in preserving. Berrone et al. (2012) expands on the concept by introducing a set of dimensions that attempts to measure SEW in a family business. The dimensions are labeled FIBER, "Family control and influence, Identification of family members with the firm, Binding social ties, Emotional attachment of family members, and Renewal of family bonds to the firm through dynastic succession" (Berrone et al., 2012, p. 259). These dimensions are further investigated and grouped into the SEWi scale as: Family Prominence, Family Continuity, and Family Enrichment (Debicki et al., 2016).

The pressure to retain SEW is a gauge for and against REM in family businesses. If there is an external threat to a company's SEW, then earnings management might be more attractive as these threats need to be defused and earnings management is a tool that can be helpful. Calabrò et al. (2020) finds the motivation to preserve SEW leads to higher REM when the threat comes from third party users of the businesses' financial statements. For example, if a vendor has a relationship with the family business and a low earnings report threatens the continued ownership or funding for the business, management might use upward REM to avoid adverse action by the vendor. The authors attribute this directly to a "preservation of the affect-related values a family derives from its ownership position" (p. 1). Stockmans et al. (2010) also finds similar results; higher SEW leads to higher earnings management.

However, several studies test the proposition that protecting reputation (Family Prominence) eclipses financial reward, driving down REM behavior. For S&P 500 companies, Wang (2006) notes that founding family ownership is most often associated with higher earnings quality which presumes lower levels of earnings management. Chen et al. (2010) finds that US public family businesses are less tax aggressive, in part due to the concern that an IRS audit might damage the business's reputation, supporting the idea that preserving SEW ranks ahead of financial gain. Ali et al. (2007) also studies the family business slice of the S&P 500 finding better quality earnings there than with their non-family counterparts. Most recently, Martin et al. (2016) finds "that potential reputational consequences of earnings management lead family principals to engage in less of this practice relative to non-family firms" (p. 453).

The findings are similar for public companies located in Europe. Both Cascino et al. (2010) and Pazzaglia et al. (2013) find that in Italian public companies, earnings quality is higher in family companies as compared to non-family companies. The results also hold in Germany, where REM is specifically tested and found to be used less frequently in listed family businesses as compared to non-family businesses (Achleitner et al., 2014). These studies emphasize the SEW viewpoint that reputational and image concerns are often more important than financial results and lead to lower levels of REM. This study posits that as SEW increases in family businesses, the cost of employing REM will rise to unacceptable levels and thus, the study predicts that companies with higher levels of SEW will generate less REM.

Hypothesis 1

The likelihood of REM will be lower (higher) for high (low) SEW small and medium private US family businesses .

Succession

Succession is not a single event but a process that can take decades (Longenecker & Schoen, 1978). Succession planning is the "identification and development of potential successors for key positions in an organization, through a systematic evaluation process and training" (*Succession Planning*, 2019). Researchers agree that "succession is the most important issue that family businesses will face" (Handler, 1994, p.133). That acknowledgment has led to much deeper work in the area to identify what might be preventing family businesses from successfully making the transfer to future generations. Many factors are reviewed: successor gender (Harveston et al., 1997), financial (De Massis et al., 2012; Barach & Ganitsky, 1995), and family relationships (Lansberg & Astrachan, 1994).

The importance of succession and the factors that impact its realization are often a primary motive for founding, second, and third-generation executive management within the family (Barach & Ganitsky, 1995; Lansberg, 1988; De Massis et al., 2008; Handler, 1994). Strong operational performance impacts succession through three primary aspects: business longevity, funding needs, and successor attraction. The most long-term of these aspects is business longevity, and it is not aided by REM. In fact, many studies support the destructive nature of REM on future operations (Jensen, 2005; Tabassum et al., 2015; Taylor & Xu, 2010).

The second component, funding needs, might increase around succession as professional management is introduced, other heirs are bought out, or the business is expanded. REM has the potential to be useful when presenting financial data to these funding sources (banks, investors, other family members). The presentation of financial stability will aid in the receipt of necessary short-term funding. Owners might see the need to use REM to manipulate the signals being sent to the funding sources during succession to ensure continued funding.

Barach and Ganitsky (1995) provide a helpful glimpse into the third way that the "health and prospects of the business" might impact successful succession in family businesses (p. 144). They find that not only does a perceived healthy business offer future funding options, but it can also present a more attractive opportunity to successors. While succession is described as "relatively easy" for mature businesses and "offspring entering the growth business may fit quite well," struggling (declining) businesses "can discourage offspring from joining them…they may not have room for the younger generation, or offer meager career opportunities" (p. 144-145). If a business is nearing, or in, their succession period, a healthier picture of the business is likely to be more attractive to successors. The desire for a smooth transition to the next generation potentially offers incentive for the transferring generation to use REM to alter the signal given to the successor through financial metrics, such as financial statements.

The shift in managerial power from the old generation to the new generation creates a climate where information and interests are potentially not aligned. The transferring generation might be solely focused on the act of succession when the successor is more

interested in the long-term viability of the business. In the succession period, the transferring generation can make business decisions that aid in the realization of their goals (succession) at the expense of the business.

The knowledge that succession is imminent creates additional incentive and opportunity for high SEW companies to participate in REM. The transferring generation will be motivated to entice, persuade, or signal to the successor generation; as well as ensure appropriate funding for the future of the business under new generational control. Without family continuity in the business, all SEW components will dissolve; therefore, pressure to succeed will be greater for high SEW companies and short-term succession achievement will override long-term stewardship. The succession pressures and desire to signal (to the successor and outsiders) will be strong for those companies with high SEW. The SEW goals (including succession) will outweigh the financial cost of REM, increasing the occurrence of REM. Thus, the study predicts that higher levels of SEW will lead to higher REM in succession. The full hypothesized model can be found in Figure 1.

Hypothesis 2

The likelihood of REM will be higher (lower) for high (low) SEW small and medium private US family businesses when succession is present (not present).

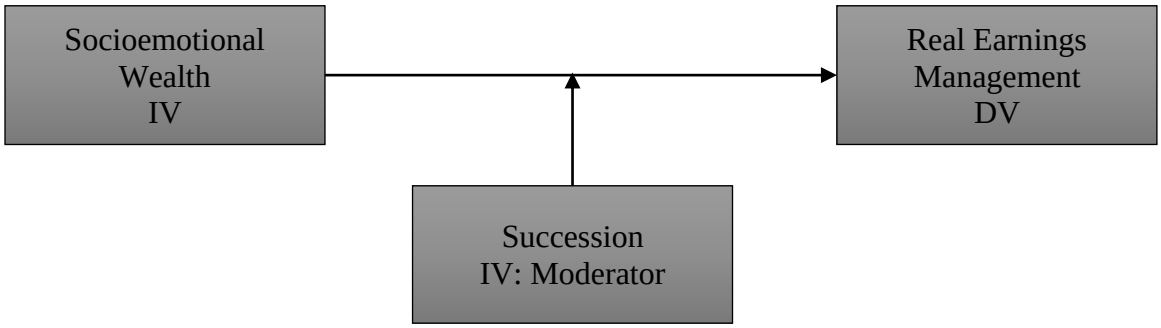

Figure 1: Model

Chapter Three

Methodology

To test the hypotheses in this study, an experiment with small and medium private family business owners was conducted. The manipulated variable was succession (present or absent) and the measured variable was SEW (continuous 1-5 and converted to categorical high/low using the above and below mean method). Participants were recruited from small and medium private family businesses in the US. Businesses were solicited from Spader Business Management (Spader Business Management) and The Bailey Program for Family Enterprise (Bailey Program for Family Enterprise | Daniels College of Business (du.edu)). In addition, snowball methods were used with local business contacts to send out invitations to participate. The invitations were not sent directly by the author, so there is no count available of total invitations distributed. Participants were not compensated for completing the experiment.

A total of 200 participants began the experiment. The experiment included five pre-qualification questions to ensure that the participants were representative of the study population. (1) Do you currently work for a company not publicly traded in the US? (2) Is the company owned by a family or families? (3) Are you a member of any family that has an ownership interest in the company? (4) Is at least one member of the family actively engaged in managing the business? (5) Does the company have 500 or fewer employees? The experiment closed for those not answering all five questions

affirmatively, resulting in the exclusion of 46 (23%) records. An additional 52 (26%) records were excluded because they did not complete the survey.

Variables

Socioemotional Wealth

SEW is the first independent variable. Debicki et al. (2016) attempts to clarify this burgeoning area of research by constructing a SEW importance (SEWi) scale provided in Table 1. The scale consists of three factors with three items each: Family Prominence, Family Continuity, and Family Enrichment (p. 52). The scale ranks each item on a scale from 1 (not important) to 5 (very important). All in-category measurements are averaged for a sub-category score (between 1-5) and then averaged for a total SEW (between 1-5).

Table 1:SEWi Scale

Family Prominence	Family Continuity	Family Enrichment
Recognition of the family in the domestic community for generous actions of the business.	Maintaining the unity of the family.	Happiness of family members outside of the business.
Accumulation and conservation of social capital.	Preservation of family dynasty in the business.	Enhancing family harmony through operating the business.
Maintenance of family reputation.	Maintaining family values through the operation of the business.	Consideration of the needs of the family in business decisions.

With the available sample of owner-managers actively participating in small and medium family businesses in the US, this study used this opportunity to measure, as opposed to manipulate, the SEW variable. Each participant was asked to complete an SEWi measurement as part of participation in the study (instrument provided in Appendix C). This method allowed the study to use a continuous variable for SEW as

well as a categorical measure (above and below mean, with no exact matches to the mean value), something rarely seen in current family business research.

There were nine questions contained within three categories to measure SEW. If the respondent did not answer at least one question in each SEW category (Family Prominence, Continuity, and Enrichment) they were excluded (6 records). If they answered at least one question in each category, the other missing values in the subcategory of that record were imputed using the mean imputation method. The method outlined by Gelman and Hill (2006) requires that the researcher "replace each missing value with the mean of the observed values for that variable" (p. 532). There were 35 (4.8%) imputations out of 729 total responses in the SEWi questions.

Succession

A plan was presented that included identification of succession to transfer control within one year to the owners' children. Approximately half (49.4%) of the sample received a succession plan and the remaining participants' scenario clearly outlined that no succession was imminent. The survey was coded 0 for no succession and 1 for the succession condition. The non-succession condition was explicit as opposed to silent. This method was chosen to eliminate any confusion for the participants as to the status of generational transfer.

Table 2: Succession Variable

Succession Variable	Non-Succession Variable
You do not intend to continue running daily operations. There is a current plan to transfer control of the business's daily activities to your children, who are current employees of the business. Your children have not yet decided if they are interested in taking over operations. The succession is expected to occur in the next twelve months.	You intend to continue running daily operations. There is not a current plan to transfer control of the business's daily activities to your children, who are current employees of the business. Your children have not yet decided if they are interested in taking over operations in the future. No succession is expected to occur in the next twelve months.

Real Earnings Management

The dependent variable of interest in this study is the decision to participate in REM. The participant was presented with financial data and strategic information about the family business, presented with a current year reporting situation, and then asked to respond with their intention to cut advertising expenses to avoid a loan covenant violation[2]. The violation would result in an increase to the loan's interest rate, notification

[2] Including salient penalties for not cutting advertising (interest rate hike, notification by bank, and loss of community event) were included to create clear motive and/or reward for making the cut (engaging in REM). The typical penalty to be avoided in an REM study is the loss in market value (decrease in stock price) when a company misses analyst's expectations. Because this penalty is not available in the private family population, the loan covenant violation was used. The study attempted to create a situation where the participant would be forced to *consider* the REM action. It is the author's belief that if a participant chose to cut advertising for any or all of the reasons associated with the violation of the loan covenant, it would be a valid decision for this study. All three repercussions were expected to move the participant in the same decision direction. Which of the three reasons (if any) were the primary motive is not the interest of this study but should be explored in future research.

of violation to all owners, and the termination of involvement in a community event. The binary variable of yes or no (1 or 0) was based on the REM question: Would you cut advertising expenses in order to meet the loan debt covenants?

Data Collection Procedures

Participants were asked to assume they were the CEO of a medium-sized US private family business. A vignette was presented that outlined three years of positive financial statements. Each participant was told that their compensation was fixed with no bonuses or incentives related to financial performance. The participants were presented with a scenario that outlined a shift in financial success for the organization in the current year:

> On September 15th of the current year, projections indicate that by December 31st the company will likely be in violation of its loan covenant because the cash balance will fall below the required balance as outlined in the company's loan agreement. This violation will trigger the following events:
>
> - An increase in the interest rate on the current $1,000,000 loan from 3.5% to 5.5%. This will decrease the company's cash balance by 10%.
> - All owners of the company will be notified of loan covenant violations directly by the bank.
> - Your company will no longer be eligible to sponsor the annual charity event hosted by the bank. Your company has sponsored the

> event for ten years where your family is recognized for your outstanding community contributions.

The participant was then told:

> The company has a long-standing marketing program that is the main reason behind the sales increases experienced over the past three years. The planned expenditures under this plan in the 4th quarter are $200,000 and would most likely not have an impact on sales until the following fiscal year. However, you are aware that if you sever this relationship with the marketing firm, you will lose access to many marketing program components and they will replace you with another client. You would no longer be able to use their services. If the entire $200,000 in these marketing expenses were cut, the debt covenants would be preserved for the current fiscal year. The interest rate will remain unchanged, owners would not receive a notice from the bank, and the company can continue to sponsor the annual bank charity event.

Finally, the participant was asked if they would cut the marketing budget to avoid the violation of the debt covenant.

In addition to the REM question, the study also collected demographic data on the participant and the company where they are currently employed. The full instrument is included in the Appendix C.

Chapter Four

Results

Binary logistic regression was used to identify any relationship between SEW (IV), succession (moderator), and REM (binary dependent variable). In addition, a *X*-square independent test was performed to identify any material difference in REM decision between the two groups (succession and non-succession or high SEW and low SEW).

Manipulation and Attention Checks

To ascertain that all participants adequately understood the information in the experiment, four attention checks were included: How many years of financial data was provided? What role did you have in the company? What was the relevant debt covenant subject to violation in the study? Are you planning to transfer day-to-day operations of the company to your children in the next fiscal year? A total of 15 records (7.5%) were excluded for failing one or more of the attention checks. The final set of usable records contained 81 (40.5%) records with 40 (49.4%) assigned to the succession condition and 41 (50.6%) assigned to the non-succession condition.

Descriptive Statistics

Participants

All participants were family business owners who currently work in the business. Approximately 84% of the respondents were male and 44% were majority

owners of the business (more than 50% ownership in the company). Panel A of Table 3 shows the very experienced characteristic of this sample with approximately 70% with work experience of more than 20 years and only 5% (4 records) with 10 or fewer years of experience.

This study focuses on small to medium sized family business and attempts to isolate this group by screening on number of employees in the company. Panel C shows the total employee counts; 63% of the participants' companies have between 21 and 100 employees and only 10% have 10 or fewer. All companies in the study but one, have 300 or fewer employees supporting the sample of SME. In addition, panel D displays the size of the companies as measured by total annual sales. Sales of at least $10 million annually describes 67 (n = 81) or 83% of this sample with 4 companies reporting annual sales of less than $1 million. Finally, Panel E indicates that nearly 73% of the participants were from the Retail industry.

Table 3: Participant Demographics

Panel A: Total Work Experience (Years)	Frequency	Percent
1-10	4	4.9
11-15	9	11.1
16-20	11	13.6
21-25	22	27.2
26-30	10	12.3
More than 30	25	30.9
Panel B: Participant Age	Frequency	Percent
25-34	5	6.2
35-44	29	35.8
45-54	27	33.3
55-64	14	17.3
65-74	6	7.4

Panel C: Employee Count	Frequency	Percent
Under 10	8	9.9
11-20	9	11.2
21-50	38	46.9
51-100	13	16.0
101-300	12	14.8
More than 500	1	1.2

Panel D: Annual Sales	Frequency	Percent
Less than $10,000,000	14	17.2
$10,000,000-$14,999,999	11	13.6
$15,000,000-$24,999,999	19	23.5
$25,000,000-$49,999,999	20	24.7
$50,000,000+	17	21.0
Panel E: Industry	Frequency	Percent
Agriculture	8	9.9
Retail	59	72.8
Transportation	3	3.7
Financial Activities	2	2.5
Leisure and Hospitality	3	3.7
Other	6	7.4

Independent Variable Socioemotional Wealth

The primary independent variable used in this study is socioemotional wealth. Each dimension of the SEWi scale (Prominence, Continuity, and Enrichment) was computed as an average for all three questions in each category, and then an average of the three subcategories was used to compute total SEW. Table 4 provides a detailed description of total records included in each calculation and the category mean. The table also includes a comparison to the Debicki et al. (2016) data where it is noted that the sample used in this study has lower SEWi levels in all categories as compared to the original data found in the Debicki et al. (2016) study.

Table 4: SEW Descriptive Statistics

	Study Mean 1-5	Debicki et al. Mean 1-5
PROM1	2.28	
PROM2	2.53	
PROM3	3.40	
PROM TOTAL	2.73	3.36
CONT1	3.56	
CONT2	2.78	
CONT3	4.21	
CONT TOTAL	3.51	4.34
ENR1	2.70	
ENR2	2.74	
ENR3	2.92	
ENR TOTAL	2.79	4.20
TOTAL SEW	3.01	3.97

In addition to collecting the SEW variable on a continuous scale (1-5), a supplementary variable was created converting SEW to a dichotomous variable (high or low). The above and below means method (no record was equal to mean) was used with a SEW mean of 3.01. The resulting grouping was 37 or 45.7% in the low SEW category (mean = 2.31) and 44 or 54.3% in the high SEW category (mean = 3.64). The study had 56.8% of those in the low SEW category cutting the advertising program and 56.8% cutting from the high SEW category. The X^2 test on this mean indicates non-significance ($p = 0.991$) between the two SEW categories.

Finally, for the SEWi scale, Cronbach's Alpha was computed using the nine sub-category questions used in the study to measure total SEW, $\alpha = 0.804$. The three subcategories also showed acceptable levels with Family Prominence, $\alpha = 0.721$; Family

Continuity $\alpha = 0.624$; and Family Enrichment $\alpha = 0.766$. Therefore, the SEW metric used in this study was determined to be a consistent measure of SEW.

Moderator: Succession

Succession is a manipulated independent variable with 40 (49.4%) participants receiving a succession condition and 41 receiving a non-succession condition (50.6%). The study resulted in 50.0% of those in the succession condition cutting the advertising program and 63.4% cutting from the no succession condition. The X^2 test on this mean indicates significance ($p = 0.043$) between the succession and non-succession conditions using a one-tailed test. It is noted that because the study was interested in the comparison of REM between the high and low levels of SEW, it has been suggested (and implemented) that a split p-value would be appropriate to reflect a one-tailed, non-directional test.

Dependent Variable: Real Earnings Management.

The measured dependent variable in the study is a dichotomous variable of yes or no noting if the participant would or would not cut the advertising program. Table 5 summarizes the REM decision by each of the four groups studied (Low SEW/Succession, Low SEW/No Succession, High SEW/Succession, and High SEW/No Succession). X^2 tests were done on all groupings and results can be found in the Table 5.

Table 5: Dependent Variable Distribution

Panel A: Proportion (Percent) of Respondents Cutting Advertising (REM)			
	SEW (Categorical)		
Succession	Low (C)	High (D)	Total
Yes (A)	5 (31.3%)	15 (62.5%)	20 (50%)
	n = 16	n = 24	n = 40
No (B)	16 (76.2%)	10 (50%)	26 (65%)
	n = 21	n = 20	n =41
Total	21 (56.8%)	25 (56.8%)	46 (56.8%)
	n = 37	n = 44	n = 81

Panel B: Chi Square Tests	Chi-Square	p-value
Succession as it moves from low to high SEW (A)	3.75	0.05**
No Succession as it moves from low to high SEW (B)	3.03	0.04*
Low SEW as it moves from Succession to No Succession (C)	7.47	0.00**
High SEW as it moves from Succession to No Succession (D)	0.70	0.41**

*one-sided p-value **two-sided p-value

Test of Hypotheses

The study employed binary logistic regression to analyze the relationship between SEW (IV), succession (moderator), and REM (DV). The main effects and interaction effect were tested with the results noted in Table 6[3].

Table 6: Model Results SEW as Categorical Variable (High/Low)

	B	S.E.	Wald	df	p-value	Exp(B)
SEW CATEGORICAL	-1.163	0.680	2.925	1	0.04*	0.313
SUCCESSION	-1.952	0.744	6.882	1	0.01**	0.142
SEW CAT x SUCCESSION	2.462	0.965	6.512	1	0.01**	11.73
Constant	1.163	0.512	5.154	1	0.02**	3.200

*one-sided p-value **two-sided p-value

[3] The model was also tested using the continuous SEW variable (1-5) finding similar results. The interaction effect (SEW x Succession) was found to have a p-value of 0.06 using the continuous variable.

Hypothesis 1

Using agency and SEW theory, H1 predicts that high SEW will decrease a company's tendency to participate in REM. This was predicted to occur due to the fear of loss of SEW, the overriding desire to do what is best for the company, and the lack of agency problems with a high level of ownership and management overlap. Support for H1 was found as high SEW was associated with a decreased likelihood of REM (Exp(B) = 0.313 and p = 0.04) indicating a minimal 24% probability that a high SEW company will use REM. In addition, the negative coefficient (B = -1.163) associated with SEW indicates that high SEW (1) will decrease the overall probability of engaging in REM. Analysis of this variable utilized a one-tailed test due to the non-directional, binary nature of H1. Given the significant interaction discussed next, I interpret the main effect with caution due to the effects of succession.

Hypothesis 2

When succession is present, H2 predicts that the relationship will shift and high SEW companies will become more likely than low SEW companies to participate in REM due to the succession pressures and change in agency dynamics. A logistic regression was performed to ascertain the effects of SEW, succession, and their interaction, on the likelihood that companies will use REM. Support for H2 was found. The logistic regression model was statistically significant, $\chi 2(3) = 8.38$, $p = 0.04$. The model explained 13.2% (Nagelkerke R^2) of the variance in REM and correctly classified 64.2% of REM cases. High SEW companies were 11.7 times more likely to use REM than low

SEW companies in succession. Figure 2 shows the moderation of SEW by succession on REM.

The results of the interaction effects of succession on SEW can be found in Panel B of Table 5[4]. It was found that as we move from low SEW to high SEW, in a succession scenario, the likelihood of REM increases (X^2 = 3.75, p = 0.03). This is depicted in Graph 1 with the solid gray line showing the upward direction of REM as we move from low to high SEW. Graph 1 also indicates that when succession is not present, the relationship shifts and REM becomes less likely as we move from low to high SEW (X^2 = 3.03, p = 0.04), shown by the dotted black line in Figure 2.

The combined hypothesis of the study suggests that the behaviors of family businesses would change as they moved from no succession to succession. Predicting that the inclination to use REM would be higher in a succession situation for high SEW companies. While high SEW companies in succession are more likely to use REM than low SEW companies, there is no significant difference found for high SEW companies in the succession condition when compared to high SEW companies in the no succession condition (X^2 = 0.70, p = 0.41). The opposite is found to be true about low SEW companies moving from no succession to succession, where the study finds a significant difference (X^2 = 7.47, p = 0.00) in behavior for low SEW companies in succession and no succession conditions. These findings suggest that the presence of succession does not create a material difference in behavior when studying high SEW companies but does

[4] Size of company as measured by total employees (p = 0.43) and total sales (p = 0.63), gender (p = 0.14) and age of participants (p = 0.09) were all tested as variables in the model and found to be insignificant.

when studying low SEW companies. This potentially occurs due to a constant mindset among high SEW companies that succession is in sight and a priority, therefore, succession does not change their behavior. This should be investigated and is discussed in suggestions for future research.

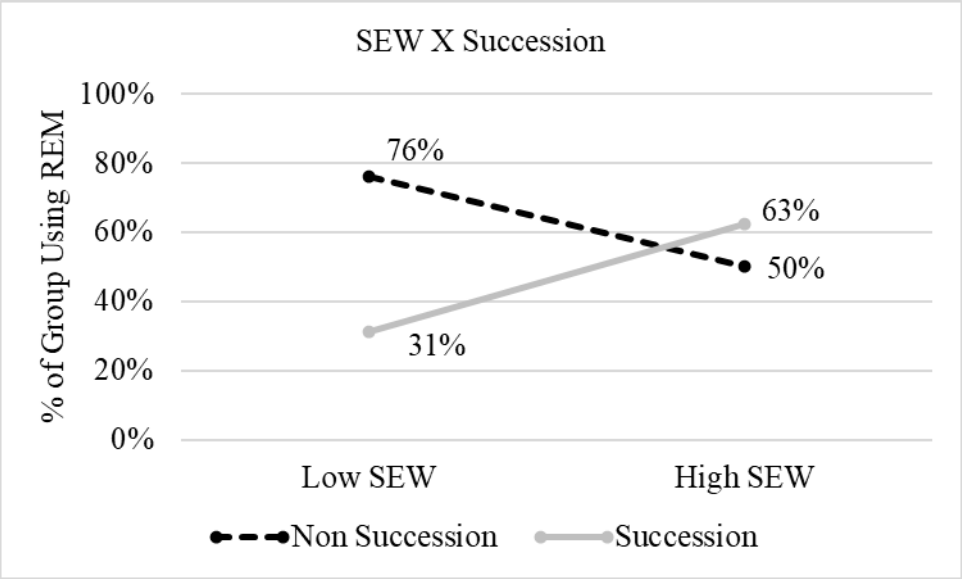

Figure 2: Succession Moderation of SEW on REM

Chapter Five

Discussion of Results

Succession is a critical stage in the life of a family business, and it is the goal of this study to determine if the pressures of this situation will create a climate that might lead to less-than-optimal decision making by families with higher levels of SEW. The study finds support that SEW and succession have an impact on REM.

When high SEW family business owners are presented with an opportunity to manage earnings, they are significantly less likely to use REM than low SEW firms. This suggests that agency problems are diminished in high SEW firms where the management and ownership are often the same. This overlap creates more alignment of interests and decreases motive and opportunity for earnings management. In addition, there is support that the high SEW company is potentially more concerned with the retention of SEW than the low SEW company and that also contributes to the aversion to REM. Finally, this study suggests that SEW likely plays a role in a company's decision to steer away from REM as it is not the best direction for the company and decision makers will choose what is best for the company, versus any personal gain.

In a succession situation, the study demonstrates a much different relationship between SEW and REM. As we move from a low level of SEW to a high level of SEW, the probability of REM increases and high SEW companies are more likely to use REM

than low SEW companies. Agency theory implies that this is potentially the result of the "forced" dispersion between ownership and management that happens in a succession situation. The managing owner moves from the position of power to a more secondary role and during the transition, there might be motive and opportunity to manage earnings to move the company in the direction they think is best. The pressure to retain SEW (especially family continuity) potentially creates additional reasons for the owner to manage earnings. They want to *signal* a positive outlook to interested parties during this period. This is done to preserve funding, obtain favorable vendor terms, retain reputation, and convince the potential successor that this is a beneficial long-lasting opportunity.

High SEW companies possibly place a higher priority on certain objectives when succession is present and SEW retention and signaling the successor override the long-term focus of stewardship. The reward of manipulating the signal using REM (community reputation, positive successor perception, family harmony) is worth the cost, making them more likely than low SEW companies to manage earnings through the manipulation of real business activities.

Implications

In practice, outside (or non-managing) parties should be aware of conditions where REM is more likely and the potential impact of the behavior. In the event of succession, many parties are often involved (family members, banks, vendors, successor, employees). These parties need to be aware of actions that might be taken on the part of a managing owner when SEW levels are high or low and succession is present or not present. A non-managing owner or successor should play an active role in management decisions during

succession so they can influence or be aware of any action that might influence the future operations of the business. Banks and investors might also be inclined to introduce additional controls into the business to account for the influencing behaviors in this study identifies.

Researchers should be interested in the findings of this study as it posits that succession is a significant moderating factor in the decision making for small and medium-sized family businesses. Succession research is an important factor that should be studied for family businesses as this study supports its impact on other significant decisions and the future health of the business.

Current research focuses on family vs. non-family businesses, and this study suggests that the dissection between firms within the family firm spectrum is also significant. Not all family businesses behave the same. Research should be expanded to include this important distinction. Why does succession impact low SEW families differently than high SEW companies? This study finds clear support of the difference that should be explored further.

Limitations

This study is not without several limitations. Although the introduction of an experiment into this field is important, it likely includes a trade-off between external validity and internal validity. The controlled setting allows the study to focus in on a very specific situation, but likely limits its generalizability. In addition, the final sample size is small which also limits the generalizability.

The design of the experiment in this study is intentionally focused on highlighting the succession climate of the business. It is the intention of the study to ensure that succession (or non-succession) was top of mind for all participants so that the study could measure any impact. However, it is likely that in practice the succession condition is not as observable and might be a more fluid process that does not have an identifiable start and stop. With the experimental focus being SEW, succession, and REM; many other business factors that would be present in practice were not discussed in the fictitious scenario, lowering its external validity.

Finally, there is strong research support that REM is not an optimal business action and that it can be harmful to the future viability of a company. REM is considered an *intentional* action with the expected outcome of disguising the actual financial results of a company. The study does not explicitly state that the cutting of the advertising program (REM) is a damaging action or that it would be considered earnings management. It is unclear if those participants who cut the advertising program are intentionally trying to mislead interested parties or if they believe their action was an optimal business decision.

Suggestions for Future Research

Although this study fills some existing gaps in the family business literature, there are many gaps remaining. An extension of this study into a larger, more diversified sample would be helpful in supporting or refuting the findings here. The majority (73%) of the participants were from the retail industry and 84% were male. Additional studies should expand into other industries to identify variances in this population across industry and/or gender.

This study provides three costs attached to the REM decision: interest rate increase, family notification, and decreased community involvement. The final two costs were SEW characteristics. However, the study did not obtain any information as to the importance of each of these on the REM decision. Additional studies measuring SEW can be more direct in these constructs and should obtain both quantitative and qualitative information about each of the costs to determine if there is variance in the weight of each in their final REM decision.

Those studies that continue to study SEW should isolate high SEW companies to identify additional factors that led to the non-significance found in the REM decision between succession and non-succession. The study could also be extended to study low SEW companies to better understand the significant difference in REM behavior in this group when succession was or was not present. This study simply scratches the surface and leads to many more questions about why the REM behavior shifts so dramatically in and among these conditions.

Future studies should work to confirm or dispute the Gunny (2010) findings that suggest in certain situations, REM can be helpful and not harmful to the value of a firm. This should be studied (possibly through a qualitative study) to see if REM in family businesses falls into this category where REM is positively correlated to future performance. It is important to note that family businesses share some of the characteristics of the businesses where Gunny (2010) finds this positive relationship (i.e. businesses just slightly missing expectations and using REM primarily to signal a positive financial outlook.)

REM research suggests that earnings management is a short-sighted decision and those that have a long-term view of the firm will steer clear of REM. The qualitative data collected in this study reveals support for this claim as the respondents that cut the advertising appeared to be focused on the short-term. Some of the associated comments for why the participant chose to use REM, “This is a short-term, plug the dam.” and “Handle immediate needs, plenty of marketing firms.” While those that did not cut appeared to be focused on the long-term health of the business with comments such as: “If the marketing drove the sales increases for the last few years, the opportunity cost for loosing those sales would be more than the savings.” and “If marketing is integral to the business, I would rather suffer personal shame then injure the business.” and finally “Would not sacrifice short term pain for long term loss in sales momentum, might look for alternative ways to improve cash balance.” Future research should expand the qualitative research that was introduced here to offer additional support for the motives for and against REM.

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Appendix A: Experiment Informed Consent

Welcome to the research study!

I am interested in understanding family businesses. For this study you will be presented with information relevant to a fictitious family business and asked to answer some questions about it. Please be assured that your responses will be kept completely confidential.

The study should take you approximately 10 minutes to complete. Your participation in this research is voluntary. You have the right to withdraw at any point during the study, for any reason, and without any prejudice. If you would like to contact the Principal Investigator in the study to discuss this research, please e-mail Beth Flambures at Beth.Flambures@du.edu.

By clicking the button below, you acknowledge:

Your participation in the study is voluntary

You are 18 years of age

You are aware that you may choose to terminate your participation in the study at any time and for any reason.

Please note that this survey will be best displayed on a laptop or desktop computer. Some features may be less compatible for use on a mobile device.

A copy of the consent form is attached.

CONSENT FORM_IRB 1897921

○ I consent, begin the study

○ I do not consent; I do not wish to participate

Appendix B: Experiment Screening Questions

Screen 1 Do you currently work, or have you previously worked, for a company not publicly traded in the US?

- ○ No (1)
- ○ Yes (2)

Screen 2 Is the company owned by a family or families?

- ○ No (1)
- ○ Yes (2)

Screen 3 Are you a member of any family that has an ownership interest in the company?

- ○ No (1)
- ○ Yes (2)

Screen 4 Is at least one member of the family actively engaged in managing the business?

- ○ No (1)
- ○ Yes (2)

Screen 5 Does the company have 500 or fewer employees?

- ○ No (1)
- ○ Yes (2)

Appendix C: Experiment Instrument

UNIVERSITY of DENVER *Student Project*

You will be provided with selected financial and non-financial information about Family Firm USA, LLC. Based on this information, you will be asked to make a decision about advertising expenses for your company.

The case information is not intended to include all the information that would be available if you were evaluating this decision for Family Firm USA, LLC. However, for the purposes of this study, base your judgments on the information provided. Please read these instructions carefully.

- Assume that you are the Chief Executive Officer for a medium sized, privately held, family firm, Family Firm USA, LLC.
- You are a member of the family that shares majority ownership of the business with your children.
- You currently run the day-to-day operations and your children are employees of the company.
- Your compensation from Family Firm USA is a fixed salary with no earnings-based bonuses.

The financial statements of Family Firm USA are reviewed annually by a regional CPA firm. Family Firm USA has no internal audit staff. The Income Statement and Balance sheet for the preceding three years are below:

Family Firm USA, LLC
Balance Sheet
Years Ended 2019-2021

	2019	2020	2021
Assets			
Operating Cash	$ 40,283	$ 352,774	$ 318,608
Other Current Assets	4,754,048	4,823,523	5,305,754
Property, Plant, and Equipment (net)	1,044,280	1,340,689	1,615,848
Intangibles (net)	1,422,955	1,422,955	1,422,955
Total Assets	$ 7,261,566	$ 7,939,941	$ 8,663,165
Liabilties & Owner's Equity			
Current Liabilities	992,554	1,068,143	1,073,035
Long-Term Debt	824,005	728,005	629,880
Owners' Equity	5,445,007	6,143,793	6,960,250
Total Liabilities & Owners' Equity	$ 7,261,566	$ 7,939,941	$ 8,663,165

Family Firm USA, LLC
Income Statement
Years Ended 2019-2021

	2019	2020	2021
Gross Profit			
Sales	10,277,495	11,509,554	12,959,779
Cost of Sales	7,480,893	8,341,149	9,379,693
Total Gross Profit	$ 2,796,602	$ 3,168,405	$ 3,580,086
Gross Profit %	*27.2%*	*27.5%*	*27.6%*
Sales Increase %	*11.8%*	*12.0%*	*12.6%*
Operational Expenses			
Fixed Expenses	450,000	450,000	475,000
Department Variable Expenses	55,000	62,312	68,442
Other Variable Expenses	185,000	289,602	275,285
Personnel Expense	989,855	1,107,705	1,284,902
Advertising Expenses	500,000	560,000	660,000
Total Operational Expenses	2,179,855	2,469,619	2,763,629
Net Income	$ 616,747	$ 698,786	$ 816,457
Net Income %	*6.0%*	*6.1%*	*6.3%*

Succession Condition

You do not intend to continue running daily operations. There is a current plan to transfer control of the business's daily activities to your children, who are current employees of the business. Your children have not yet decided if they are interested in taking over operations. The succession is expected to occur in the next twelve months.

Non- Succession Condition

You intend to continue running daily operations. There is not a current plan to transfer control of the business's daily activities to your children, who are current employees of the business. Your children have not yet decided if they are interested in taking over operations in the future. No succession is expected to occur in the next twelve months.

On September 15th of the current year, projections indicate that by December 31st the company will likely be in violation of its loan covenant because the cash balance will fall below the required balance as outlined in the company's loan agreement. This violation will trigger the following events:

- An increase in the interest rate on the current $1,000,000 loan from 3.5% to 5.5%. This will decrease the company's cash balance by 10%.
- All owners of the company will be notified of loan covenant violations directly by the bank.
- Your company will no longer be eligible to sponsor the annual charity event hosted by the bank. Your company has sponsored the event for ten years where your family is recognized for your outstanding community contributions.

The company has a long-standing marketing program that is the main reason behind the sales increases experienced over the past three years. The planned expenditures under this plan in the 4th quarter are $200,000 and would most likely not have an impact on sales until the following fiscal year. However, you are aware that if you sever this relationship with the marketing firm, you will lose access to many marketing program components, and they will replace you with another client. You would no longer be able to use their services.

If the entire $200,000 in these marketing expenses were cut, the debt covenants would be preserved for the current fiscal year. The interest rate will remain unchanged, owners would not receive a notice from the bank, and the company can continue to sponsor the annual bank charity event.

Please provide responses to the following questions which relate to your recommendation.

Would you cut the marketing plan in order to meet the loan debt covenants?

- ◯ No
- ◯ Yes

How much would you cut? Remember that $200,000 is needed to preserve the loan covenants.

You can choose to cut anywhere from $0 to $200,000.

0 20 40 60 80 100 120 140 160 180 200

Amount of Marketing Cut in Thousands ($000)

How confident are you in your decision?

- ◯ Extremely confident
- ◯ Moderately confident
- ◯ Slightly confident
- ◯ Neither confident nor not confident
- ◯ Slightly not confident
- ◯ Moderately not confident
- ◯ Not confident at all

In the space provided below provide one to two reasons to support your decision.

The following questions relate to your understanding of the case scenario.

How many years of financial data was provided?

- ◯ 1 Year
- ◯ 3 Years
- ◯ Unknown

What role did you have in the company?

- ◯ Chief Executive Officer
- ◯ Bookkeeper

In the case, are you planning to transfer day-to-day operations of the company to your children in the next fiscal year?

- ◯ No
- ◯ Yes
- ◯ Unknown

What was the relevant debt covenant subject to violation in the study?

- ◯ Cash Balances
- ◯ Tax Expense

The following questions are aimed at better understanding your family business's priorities.

For your family business, please provide responses to the following questions. On a scale of 0-5, indicate how important each item is to your family business.

	Not at all important	Slightly important	Moderately important	Very important	Extremely important
Recognition of the family in the domestic community for generous actions of the firm.	○	○	○	○	○
Accumulation and conservation of social capital.	○	○	○	○	○
Maintenance of family reputation.	○	○	○	○	○
Maintaining the unity of the family.	○	○	○	○	○
Preservation of family dynasty in the business.	○	○	○	○	○
Maintaining family values through the operation of the business.	○	○	○	○	○
Happiness of family members outside of the business.	○	○	○	○	○
Enhancing family harmony through operating the business.	○	○	○	○	○
Consideration of the needs of the family in business decisions.	○	○	○	○	○

The following questions are aimed at better understanding you as a decision-maker.

Please indicate the extent to which you agree or disagree with the following statement. Please do not think too long before answering; usually your first inclination is also the best one.

Strongly disagree 0 1 2 3 4 5 6 7 Strongly agree 8

Safety first.

I do not take risks with my health.

I prefer to avoid risks.

I take risks regularly.

I really dislike not knowing what is going to happen.

I usually view risks as a challenge.

I view myself as a risk avoider.

Please provide responses to the demographic questions below about yourself.

Please indicate your gender.

- ◯ Male
- ◯ Female
- ◯ Non-binary / third gender
- ◯ Prefer not to say

What is your age?

- ◯ Under 18
- ◯ 18 - 24
- ◯ 25 - 34
- ◯ 35 - 44
- ◯ 45 - 54
- ◯ 55 - 64
- ◯ 65 - 74
- ◯ 75 - 84
- ◯ 85 or older

How many years of business work experience do you have?

- ◯ Less than 1
- ◯ 1-5
- ◯ 6-10
- ◯ 11-15
- ◯ 16-20
- ◯ 21-25
- ◯ 26-30
- ◯ More than 30

How many years of business work experience with your current business do you have?

- ◯ Less than 1
- ◯ 1-5
- ◯ 6-10
- ◯ 11-15
- ◯ 16-20
- ◯ 21-25
- ◯ 26-30
- ◯ More than 30

What % of the business do you own?

0 10 20 30 40 50 60 70 80 90 100

What is your position with the company?

Please provide responses to the questions below about the business you currently work for.

What is your company's annual sales?

- ◯ Less than $100,000
- ◯ $100,000 - $499,999
- ◯ $500,000 - $999,999
- ◯ $1,000,000 - $4,999,999
- ◯ $5,000,000 - $9,999,999
- ◯ $10,000,000 - $14,999,999
- ◯ $15,000,000 - $24,999,999
- ◯ $25,000,000 - $49,999,999
- ◯ $50,000,000 - $99,999,999
- ◯ $100,000,000 or more
- ◯ Prefer not to say

How many full-time employees work for your company?

- ◯ Under 5
- ◯ 5 - 10
- ◯ 11 - 20
- ◯ 21 - 50
- ◯ 51 - 100
- ◯ 101 - 200
- ◯ 201 - 300
- ◯ 301 - 400
- ◯ 401 - 500
- ◯ More than 500

Do you consider your current business a family business?

- ◯ Definitely not
- ◯ Probably not
- ◯ Might or might not
- ◯ Probably yes
- ◯ Definitely yes

How many members of the family actively work in the business?

Does the family intend to keep the business in the family?

- ◯ No
- ◯ Maybe
- ◯ Yes

What industry do you consider your business to be part of?

- ◯ Construction
- ◯ Education and Health Services
- ◯ Financial Activities
- ◯ Information Technology
- ◯ Leisure and Hospitality
- ◯ Manufacturing
- ◯ Natural Resources and Mining
- ◯ Professional and Business Services
- ◯ Retail
- ◯ Other