Financial Reporting and the Protection of Socioemotional Wealth in Family-Controlled Firms

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Investors, regulators, financial institutions and other stakeholders attach a lot of importance to the financial statements of firms. Financial reporting addresses the need for transparency and credibility of the firm's business standing. A family firm holds its reputation quite dearly, which can be greatly influenced by the reporting practices it follows. Hence, these reporting practices warrant a deeper study. In this paper, drawing on the extant literature, the authors present an integrated theoretical framework of financial reporting decisions at family controlled firms. More specifically, they postulate how the owner family's objective of socioemotional wealth (SEW) preservation influences financial reporting decisions at family firms.

Financial Reporting: Earnings Management and Voluntary Disclosure

Managers are often willing to exploit accounting discretion to meet stakeholder expectations. The authors state that financial reporting decision is like a gamble in which managers choose the extent to take risks to engage in earnings management and disclosure activities. The expected rewards for these risks are the benefits that accrue from the firm 'looking good' to the stakeholders.

The phenomenon of abusing discretion in financial reporting has been examined from the agency theory perspective. Powerful and opportunistic managers are known to engage in this behaviour, often at the expense of other stakeholders. However, the authors are puzzled as to why this practice is also found in family firms, where there is no separation in ownership and control? In addition, managerial discretion is supposed to be under check in family firms due to the presence of a controlling owner. Yet at times, quality of financial reporting at family firms gets adversely affected. The authors attribute these aberrations to non-financial objectives that drive family firm behaviour.

Influence of SEW on Financial Reporting by Family Firms

Family firms are usually known to have better quality of financial reporting compared to their non-family peers. However, some studies also show a negative relationship between family control and quality of financial reporting. The authors describe this phenomenon with the help of the dimensions of the SEW preservation model.

The SEW model suggests that family firm decisions are often influenced by their likely impact on socio-emotional bonds among family members. Family firms aim at preserving SEW, sometimes even at the cost of forgoing financial gains.

The authors posit that ***'Family Control and Influence'*** and ***'Family Identity'*** dimensions of SEW serve as important reference points while making financial reporting decisions at family firms.

1. Family Control and Influence: It refers to the owner family's desire to maintain direct or indirect family control over the firm's strategic decisions. According to the authors, it influences financial reporting in the following manner:

a. When family owners prioritize on control dimension, they may take the gamble of manipulating/ ***managing earnings*** at the expense of potential reputational costs to the family (in case of the violation being exposed in future). Hence, they may report inflated financial numbers to keep stakeholders satisfied with the firm's management.

b. They will also be ***reluctant in providing disclosures*** due to their detrimental effects on family's control. Even in case the disclosures are provided, those may be less credible.

2. Family Identity: This SEW dimension refers to the extent to which the family owners identify the firm with the family. In many cases, the firm itself becomes a projection of family and its core values. This makes the family owners quite sensitive to the firm's reputation. This would influence reporting as following:

a. When family identity dimension is more salient, preserving the family's image and reputation is paramount. Any potential damage to the firm's reputation poses a threat to the family's identity. Therefore, in this case the firm is ***not (or less) likely to engage in earnings management***.

b. The firm management would prefer ***more disclosures*** in order to maintain family reputation. Saving face with disclosure would be preferred over withholding bad news that may damage family standing.

to a more long-term view and the business may adopt a pro-sustainability stance. On the contrary, loss of a key family leader may make others detached to the idea of preservation.

Practical Implications

The key practical implication of the study is that family firms would do well if they recalibrate their SEW preservation priority, as this would be reflected in their financial reporting practices. If they solely act with the objective of maintaining family control over the firm, they are more likely to be susceptible to adverse financial reporting practices. These would entail adopting earnings management and curtailing disclosures. Though these practices may provide short-term benefits, the long-term costs in terms of loss of family reputation can more than offset the gains.

On the other hand if the firm prioritizes family reputation dimension of SEW, then it is less likely to indulge in earnings management and would be more open to disclosures. Though adopting such financial reporting practices these may lead to short term setbacks, the long term gains will be the firm's continued reputation and trust. This will also contribute to sustenance of the family's control over the firm.

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