The Influence of Family Ownership on Long-Lived Asset Write-Offs

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Evidence continues to mount on the differences between family and nonfamily firms. Differences that manifest in both the *resourcing* of, and *reporting* about, their enterprises. Not only do we now know where, why, and when they mobilise financial, human, and organizational resources differently but also we are learning more about their differential reporting practices.

This paper adds to the evidence about where, why, and when family firms **report** their resource use performance differently. Broadly, the authors seek to establish if the accounting behaviors (discretionary accounting choices) of family firms generate higher earnings quality/overall financial reporting quality than nonfamily firms. Specifically *where* they seek to establish the *when* and *why* of differential behaviors of family firm managers is in the context of long-lived (tangible and intangible) asset write-offs.

Their findings show that nonfamily firms use write-offs for earnings management purposes whereas family firms report write-offs that are coherent with firm performance.

Earnings management
This is defined as:

The purposeful intervention by management in the earnings determination process, usually to satisfy selfish objectives. It can be real or cosmetic:

- *Cosmetic* when managers manipulate accruals without any cash flow consequences;
- *Real* when managers take actions with cash flow consequences for purposes of managing earnings (e.g., increasing or decreasing product prices).

Although earnings management uses acceptable accounting reporting principles, it is usually viewed as negatively related to earnings quality. There are three main strategies for determining the different likelihood of adoption of earnings management strategies in family vs. nonfamily firms:

1. *Increasing income* (i.e., increasing a period's reported income to portray a company more favorably), for example through delaying expense recognition by capitalizing expenses and amortizing them over future periods, or shifting expenses to later periods by adopting the FIFO method for inventory valuation or the straight-line (versus accelerated) depreciation;

2. *Income smoothing* (i.e., decreasing or increasing reported income with the aim of reducing its volatility), for example by not reporting a portion of earnings in good years through creating reserves, and reporting them in bad years;
3. *"Big bath"* (i.e., taking as many write-offs as possible in one period, hence making subsequent earnings look better), for example by taking large one-time charges such as asset impairments and restructuring charges on an intermittent basis.

Now the incentives to engage in earnings management practices, those so-called "selfish objectives," really only come into play in the case of publicly listed companies. Therefore the authors use data from Italian publicly listed family and nonfamily companies:

- Family ownership is when a family directly or indirectly owns 30% or more of the voting shares;
- The observation period was 2006-2010 (followed by a post write-off performance review to 2012);
- 142 individual firms (82 family, 60 nonfamily) were studied over the period that provided 710 firm-year observations.

When

The authors examine when the write-offs of tangible and intangible assets occur in terms of *pre-write-off earnings* scenarios and in the event of *management changes*. They consider three circumstances:

1. Positive pre-write-off earnings (no difference)
2. Negative pre-write-off earnings (stronger for nonfamily firms)
3. Management changes (stronger for nonfamily firms)

When pre-earnings are positive there is no significant difference in the reporting of write-offs between family and nonfamily firms although the indications suggest that nonfamily behaviour hints at having possible earnings management purposes. However when pre-earnings are negative the results show that nonfamily firm managers are more prone to undertaking write-offs whereas family firm managers do not opportunistically undertake unnecessary write-offs.

The final circumstance considered was when there is a management change and it is only in the case of nonfamily firms that significant results are obtained showing nonfamily management change is associated with an additional 1.8% in write-offs.

In summary the authors find that family firms report write-offs that are less manipulated and more coherent with firm performance than nonfamily firms who report write-offs for earnings management purposes.

Why

In seeking to explain why these differential behaviors are observed in family and nonfamily firms, the authors suggest that family firm managers are less interested in using write-offs for earnings management purposes due to the absence of agency conflicts or the alignment between owners and managers objectives.

The findings are consistent with the family owners' concerns about the firm value, their reputation damage and their investors' and lenders' negative reactions.

Practical implications

The main practical implication for publicly listed family firms is that enhanced earnings quality that comes from less self-interested discretionary choices creates trust among the investor community because of the greater reliability of the reported results. This not only enables investors and lenders to forecast more accurately but also to develop better fair value estimates of the company's worth.

About the contributor

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