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CLAUDIA FRISENNA

EARNINGS QUALITY IN LISTED FAMILY FIRMS

THEORY AND EVIDENCE

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INDEX

INTRODUCTION

The early 2000s were marked by a series of financial scandals that shook the foundations of the global financial system. Firms like Enron and Parmalat were at the epicenter of these crises, revealing significant flaws in financial reporting and corporate governance.

Arthur Levitt, former Chairman of the Securities and Exchange Commission (SEC), in his famous speech *The Numbers Game*[1] brought to light a critical issue in the financial world: the progressive deterioration of the quality of financial reporting, attributing it to the spread of earnings management practices aimed at presenting desired numbers rather than actual company performance, thereby stripping financial statements of their fundamental characteristic: the reliability of the information they contain and the truthful representation of corporate performance.

These financial shocks served as a wake–up call, highlighting the critical importance of earnings quality for the stability of the entire economic system. Financial reporting is, indeed, an essential tool for safeguarding investors and stakeholders' rights, providing transparency and accountability, and facilitating informed decision–making by investors and other stakeholders.

Once predominantly confined to academic debate, the quality of financial information has now emerged as a critical concern for

(1) A. Levitt, *The "numbers game"*, NYU Center for Law and Business, NY, 1998.

regulators, investors, and corporate stakeholders. This increased awareness is crucial for identifying the drivers of earnings quality, recognizing the incentives that may drive earnings manipulation, and detecting the green and red flags signaling potential issues. However, prior studies have primarily focused on contexts in which ownership and control are separated, highlighting the potential threats posed by the opportunistic use of managerial accounting discretion on the reliability of earnings[2].

This has contributed to the belief that that the issue of earnings management is less relevant in contexts of concentrated ownership, as the involvement of a controlling shareholder is assumed to act as a deterrent to the engagement in earnings management practices.

However, over the past decade, researchers have increasingly questioned this assumption, especially in the context of family firms[3].

Family firms present distinctive governance challenges, particularly concerning the risk of entrenchment, which occurs when controlling family members prioritize personal benefits over other shareholders' wealth. Such behavior can manifest in various forms, including related–party transactions, nepotism, or strategic decisions that serve the family's interests rather than those of the company or its shareholders. These private benefits of control can adversely affect minority shareholders' wealth, particularly if financial disclosure is used as a means to conceal family–oriented decisions[4].

Such characteristics call for a closer examination of the relationship between family firms and earnings quality.

The academic literature has offered conflicting views on the nature of family firms. On one hand, some scholars emphasize the *bright side* of family firms, highlighting their long–term orientation, commitment to legacy, and strong focus on maintaining a positive reputation and corporate image. On the other hand, other scholars underscore the

(2) S.J. Dempsey, H.G. Hunt III, N.W. Schroeder, *Earnings management and corporate ownership structure: An examination of extraordinary item reporting*, «Journal of Business Finance & Accounting», 20(4), 1993, pp. 479–500; A. Shleifer, R.W. Vishny, *Large shareholders and corporate control*, «Journal of Political Economy», 94(3, Part 1), 1986, pp. 461–488.

(3) A. Prencipe, S. Bar–Yosef, H.C. Dekker, 2014, *op.cit.*; C. Salvato, K. Moores, 2010, *op.cit.*

(4) H.C. Kang, J. Kim, *Why do family firms switch between family CEOs and non–family professional CEOs? Evidence from Korean Chaebols*, «Review of Accounting and Finance», 15(1), 2016, pp. 45–64.

dark side of family firms, characterized by the prioritization of family interests, a tendency to maintain absolute control, and an aversion to external interference in management. Empirical evidence on earnings quality, and particularly earnings management, in family firms is similarly conflicting.

This book aims to explore the complexities of family firms' dynamics and their impact on earnings quality. A crucial point is that family firms cannot be treated as a homogeneous category. Instead, they differ significantly in terms of governance structures, objectives, and non–economic incentives. By identifying specific elements of heterogeneity and their role in affecting earnings quality, this book seeks to disentangle the relationship between earnings quality and family firm characteristics. The ultimate contribution is to identify potential *red flags* — indicators that may signal entrenchment incentives and affect the reliability of earnings. Additionally, it also seeks to highlight potential *green flags* — indicators that reduce entrenchment incentives and promote accountability in financial reporting. To achieve this aim, the book is structured as follows:

Chapter 1, entitled *Earnings Quality: Definitions, Core Concepts, and Debate*, discusses the fundamental issues surrounding earnings quality in corporate financial reporting.

It begins with a comprehensive critical examination of the *earnings quality construct*, highlighting the definitional challenges associated with adopting either a holistic or a quantitative approach. The chapter provides an in–depth analysis of the qualitative characteristics essential for high–quality financial information, as defined by international standard–setters, namely relevance and faithfulness.

It then proceeds with a description of the quantitative measures developed in the literature to assess the key dimensions of earnings quality, offering a critical analysis of these methods. The chapter underscores the complexities that arise when adopting a quantitative perspective, emphasizing the importance of a careful and parsimonious approach to avoid oversimplification.

The chapter concludes with an in–depth examination of earnings management, discussing its antecedents and consequences, as well as the primary econometric techniques used to measure it. The discussion highlights the theoretical and conceptual limitations of these methods, providing a nuanced understanding of the complexities involved in assessing earnings management and its relationship with earnings quality.

Chapter 2, entitled *Family Firms: Governance Dynamics, Heterogeneity, and Implications for Earnings Quality*, introduces the topic of family firms, presenting their economic significance and highlighting key governance issues that distinguish them from non–family firms. The chapter offers an overview of the unique characteristics of family firms and explores the theoretical constructs employed in the accounting literature to interpret their decision–making processes and behavior.

It then addresses the topic of earnings quality in family firms, providing a thorough review of the collected evidence, and highlighting the conflicting findings regarding the quality of financial reporting and earnings management practices in family firms compared to non–family firms.

The chapter emphasizes the importance of considering the heterogeneity within family firms, arguing family firms' heterogeneity may serve as a key explanatory factor for the conflicting insights found in the existing literature.

Chapter 3, entitled *Disentangling Earnings Quality in Family Firms. A Conceptual Framework on The Role of Heterogeneity*, proposes a theoretical framework aimed at disentangling the relationship between family firms and earnings quality. It suggests to unravel this complex relation by examining the main dimensions of family firm heterogeneity. The framework draws on agency theory and recognizes both the positive implication (*alignment effects*) and negative implications (*entrenchment effects*) of concentrated family ownership on earnings quality. Then, it focuses on the main drivers of family firms' heterogeneity, in terms of governance structures and non–economic incentives, and their impact on earnings quality.

Specifically, the framework recognizes the risks of entrenchment and identifies mitigation factors, namely the presence of a non–family CEO, the aversion to reputational risk, and a strong commitment to legacy. The chapter develops hypotheses that form the basis for the empirical research presented in the following chapter.

Chapter 4, entitled *Empirical Investigation of Earnings Quality in Italian Listed Family Firms. Research Design, Methods and Empirical*

Findings, proposes the empirical investigation of earnings quality in the context of Italian listed family firms. Specifically, it describes the research design, methods, and findings, and provides evidence consistent with the theoretical framework proposed.

Chapter 5, entitled *Earnings Quality in Family Firms: Critical Insights and Conclusions*, discusses the empirical findings. It critically evaluates the implications of these findings for both theory and practice, particularly in the realms of accounting and corporate governance literature. The chapter summarizes the theoretical contributions, particularly in disentangling the multifaceted effects of family ownership on earnings quality. This theoretical advancement aligns with the most recent developments in family business studies within the realm of accounting research and responds to calls from prior researchers to provide explanations for the conflicting evidence found in this area. The chapter also outlines practical contributions for managers, analysts, auditors, and financial statement users, stemming from the identification of potential indicators of critical issues in the financial statements of family firms.

Additionally, the chapter addresses the limitations of the study and proposes areas for future research, suggesting the application of the proposed theoretical model in several dimensions of accounting quality.

CHAPTER I

EARNINGS QUALITY
DEFINITIONS, CORE CONCEPTS, AND DEBATE

This chapter provides an overview of the topic of earnings quality, its definitional challenges in both the Italian and international contexts, particularly highlighting the divergences related to the use of accounting discretion in financial reporting. Finally, it offers a brief examination of the qualitative characteristics deemed fundamental for quality and the main econometric techniques used to measure them, with a particular focus on their limitations from a theoretical and conceptual perspective.

1.1. Earnings Quality in the Italian Academia of *Economia Aziendale*. A Holistic Approach

The concept of earnings quality has been extensively addressed within the Italian *Economia Aziendale* Academia, where the concept of *earnings* assumes a strategic profile that goes beyond its accounting nature[1].

(1) For in–depth insights on the concept of earnings, see: P.E. Cassandro, *Il profitto dell'impresa e la sua determinazione*, in *Rassegna Economica*, Napoli, n.5, 1967; G. Catturi, *Considerazioni su temi di economia aziendale. La gestione d'impresa*, Istituto di Ragioneria, Facoltà di Scienze Economiche e Bancarie, Siena, 1983; A. Ceccherelli, *Economia aziendale e amministrazione delle imprese*, Editrice Universitaria, Firenze, 1961; T. D'Ippolito, *Istituzioni di amministrazione aziendale*, Abbaco, Palermo, 1966; P. Lizza, *La qualità del reddito*, Giappichelli Torino, 1999; M. Moscardino, *Capitale e reddito. Aspetti ragioneristici ed economici*, Isedi, Milano, 1988; P. Onida, *La logica e il sistema delle rilevazioni quantitative*

Consistently, studies on *earnings quality* provide *management–based* definitions, which stem from a holistic view of the firm management and the role of financial statement in assessing economic performance as the direct outcome of several strategic decisions in a long–term perspective[2].

For instance, Coda (1987)[3] describes earning quality as the imprint left on economic performance results by management that is either more or less short–sighted or forward–looking, more or less concerned with exploiting favorable environmental and business conditions, rather than building a success on solid foundations. Parolini (1993)[4] adds that high–quality earnings results from management not aimed at achieving contingent results, but from management that aims to build solid competitive and social foundations on which to base long–term profitability.

It is interesting to note how this conceptualization of earnings quality is deeply linked to the appreciation of the quality of the management that produced those earnings. This contrasts with the international view of earnings quality, predominantly Anglo–Saxon in origin, which will be described in the next paragraph. In essence, the contemporary international definitions arise from a concern about the opportunistic use of accounting discretion and attempt to ensure, as much as possible, that the accounting numbers accurately reflect the "*true*" results of the period.

Regarding accounting discretion, and the scope for which it is employed, there is an observable conceptual evolution in the Italian doctrine. This evolution process begins by framing the use of accounting

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d'azienda, Giuffré, Milano, 1970; N. Rossi, *L'economia d'azienda e i suoi strumenti d'indagine*, Utet, Torino, 1966; G. Zappa, *Il reddito d'impresa*, Giuffré, Milano, 1950.

(2) Historically, there has been an extensive debate on how to best define earnings quality, reflecting the complexity of this concept, and the varying contexts in which it can be applied. However, the different definitional perspectives emphasize the importance of understanding earnings quality not just through quantitative metrics but also through a nuanced, qualitative lens that accounts for the unique characteristics of each business environment. This holistic approach contrasts with the international view that tends to focus predominantly on quantitative measures. For an historical overview, see: F. Capalbo, *Earnings management, politiche di bilancio e falso in bilancio. Il difficile confine tra uso ed abuso della discrezionalità degli amministratori in sede di valutazione*, «Rivista Italiana di Ragioneria e di Economia Aziendale», 116(5, 6, 7, 8), 2016, pp. 255–274.

(3) V. Coda, *Le analisi di bilancio a fini di valutazione strategica dell'impresa*, in *Studi in onore di Ubaldo De Dominicis*, Lint, Trieste, 1987, p. 1342.

(4) C. Parolini, *Qualità del profitto e funzionalità duratura d'impresa*, in *Scritti in onore di Carlo Masini*, I, Egea, Milano, 1993, p. 784.

discretion within a stewardship perspective, and gradually evolves towards a progressive criticism[5].

To fully understand this evolution, it is first necessary to consider that, the foundation of the Italian Academia is built around the idea that a firm is a "ongoing economic coordinated entity[6]", whose management is continuous over time and space. From this viewpoint, annual financial statements and the assignment of economic results to a single fiscal year are seen as artificial constructs. These constructs are acceptable only if they serve as an anticipation on the income over the entire firm's life, thus approximating its long–term performance[7].

This philosophy is exemplified in the seminal work of Onida (1974)[8], who explains accruals accounting distinguishing between *physical time* and *economic time*. Onida proposed that from the perspective of physical time, each fiscal period is distinct and the economic results should be based solely on events occurring within that period (*reddito prodotto*). Conversely, from the perspective of economic time, each fiscal period is interconnected, and economic results are aggregated over the firm's entire life. This interpretation leads to the allocation of income components to different periods based on future management prospects. For instance, multi–year costs are distributed according to economic conditions, with higher depreciation rates in favorable periods and lower rates in adverse periods[9]. This creates economic sol-

(5) Regarding the evolution in the Italian doctrine on the use of accounting discretion, see: G. Leoni, C. Florio, *A comparative history of earnings management literature from Italy and US*, «Accounting History», 20(4), 2015, pp. 490–517. The authors identify three phases of this process. In the first phase (1930s–1970s), Italian Academia, dominated by Zappa paradigm, accounting policies were viewed favorably by scholars and researchers. A second phase (1970s–2000s) is characterized by a progressive tendency to condemnation of a misuse of accounting discretion. In the third phase, which extends to the present day, the literature has predominantly focused on a perspective tied to managerial opportunism, mostly referred to as earnings management.

(6) G. Zappa, *Tendenze nuove negli studi di ragioneria. Prolusione dell'anno accademico 1929–1927 nel Regio Istituto Superiore di Scienze Economiche e Commerciali di Venezia,* Ist. Ed. Scientifico, Milano, 1927, p. 30.

(7) D. Amodeo, *Scritti di Ragioneria*, Giannini, Napoli, 1962.

(8) P. Onida, *Natura e limiti della politica di bilancio*, «Rivista dei dottori commercialisti», 1(3), 1974, pp. 423–454.

(9) For more details, see: A. Mura, G. Roberto, *Il dualismo tra tempo fisico ed economico nell'identificazione dei fini del bilancio: dal dibattito dottrinario all'evidenza empirica delle imprese italiane*, in *Il mondo che cambia*, Franco Angeli, Milano, 2019, pp. 222–232.

idarity between different fiscal periods, considering the company's performance over a longer timeframe(10).

The concept of economic time results in determining a smoothed and stable economic result, reflecting the average profit–generating capacity of the firm. The profit thus determined can be distributed to firm's owners (*reddito consumabile*), without compromising the future prospects(11).

From these considerations, a clear strategic perspective emerges regarding the use of accounting discretion, which, within appropriate limits of reasonableness, appears free from negative connotations. That is, the way in which positive and negative income components are allocated across various fiscal years, in a logic of *economic solidarity*, constitutes one of the strategic decisions of a *farsighted* manager. In other words, it refers to "*accounting policy*"(12).

In this regard, it may be useful to recall the words of Amodeo (1956), who stated that "accounting policy is not synonymous with anything artificial, insincere, or false, even though it is susceptible to degrading to that level. Rather, it aims to express consistency with general principles of business conduct, adaptation to changing environmental and market conditions, evaluation of opportunities and attempts to turn them to the advantage of management, and harmonization of the reported results with the changing objectives pursued(13)".

This reference to the strategic use of accounting discretion, or *accounting policies*, must be related to the specific characteristics of the Italian context and the role that financial statements played within it(14). Indeed, the Italian context is characterized by the prevalence of small

(10) G. Ferrero, *La valutazione del capitale di bilancio: logica economico–quantitativa della valutazione, legislazione vigente e direttive comunitarie, principi contabili*, Giuffré, Milano, 1988.

(11) E. Ardemani, *Il valore del presunto realizzo come parametro di riferimento*, in *Bilancio d'esercizio e amministrazione delle imprese. Studi in onore di Pietro Onida*, Giuffré, Milano, 1981.

(12) The international literature coins the term *white earnings management* or *beneficial earnings management* to refer to the adoption of accounting practices that allow to increase earnings informativeness regarding future financial prospects. See, for example, M.D. Beneish, *Earnings management: a perspective*, «Managerial Finance», 27(12), 2001, pp. 3–17.

(13) D. Amodeo, *Le gestioni industriali produttrici di beni*, U.T.E.T., Torino, 1956, p. 376.

(14) For an in–depth examination of the role of contextual variables in the development of the prevailing Italian doctrine, see S. Coronella, G. Risaliti, R. Verona, *La politica di bilancio nella dottrina economico–aziendale: riflessioni critiche*, in *Il governo aziendale tra tradizione e innovazione*, (edited by L. Marchi, R. Lombardi, L. Anselmi), Franco Angeli, Milano, 2016.

and medium–sized enterprises, in which the figure of *owner–manager* is predominant. In this context, financial statements mainly served as an internal information tool for the distribution of income[15], defined as the variation in wealth provided by the owners due to business operations[16]. Smoothed income was considered a useful policy to assign adequate remuneration to shareholders, while preserving the capability to generate positive earnings in subsequent years[17].

Over time, this perspective evolved, together with changes in the institutional context, accounting harmonization processes, and the growth of capital markets[18].

The noble reasons that originally led Italian *Maestri* to consider the strategic use of accounting discretion from a stewardship perspective, clashed with the external pressures for reliable and comparable financial information[19]. These external claims indeed appeared justified in light of the numerous evidences proving managerial opportunistic behavior in the use of accounting discretion, as theorized by agency scholars[20]. With the expansion of capital markets and the ongoing process of economic globalization, the role of financial statements also evolves[21],

(15) A. Ceccherelli, *Il linguaggio dei bilanci*, Le Monnier, Firenze, 1961; F. Melis, *Storia della ragioneria*, Zuffi, Bologna, 1950.

(16) G. Zappa, 1950, *op. cit.*

(17) For insights on income smoothing and capital preservation within a going concern perspective, see A. Amaduzzi, *Conflitto ed equilibrio di interessi nel bilancio dell'impresa*, Cacucci, Bari, 1949; E. Ardemani, *Studi e ricerche di ragioneria*, Giuffrè, Milano, 1986; P.E. Cassandro, *Le riserve occulte*, Tipografia Editrice Andriola, Bari, 1946; V. Coda, G. Frattini, *Valutazioni di bilancio. Principi economici, norme civili, norme fiscali e direttive comunitarie*, Libreria universitaria editrice, Venezia, 1980; P. Onida, *Il bilancio d'esercizio nelle imprese*, Giuffrè, Milano, 1951.

(18) G. Leoni, C. Florio, 2015, *op. cit.*

(19) The shift in the paradigm regarding the use of accounting discretion was actually a response to the external demand for clarity and truthfulness in the financial statements. For instance, external pressures determined a growing consensus towards the use of physical time rather than economic time (A. Provasoli, *Il bilancio d'esercizio destinato a pubblicazione,* Giuffrè, Milano, 1974).

(20) Among the pioneering studies, see for instance: P.M. Healy, J.M. Wahlen, *A review of the earnings management literature and its implications for standard setting*, «Accounting Horizons», 13(4), 1999, pp. 365–383; K. Schipper, *Commentary on earnings management*, «Accounting Horizons», 4(3), 1989, pp. 91–102; R.L. Watts, J.L. Zimmerman, *Towards a positive theory of the determination of accounting standards*, «The Accounting Review», 53(1), 1978, pp. 112–134.

(21) A. Quagli, *Bilancio di esercizio e principi contabili*, Giappichelli, Torino, 2023, p.7.

with greater emphasis given to the function of evaluating management's performance (*redde rationem*)[22]. In the context of capital markets, financial statements must attenuate the information asymmetries of external stakeholders, particularly investors and lenders, who need to rely on faithful accounting data to *efficiently allocate financial resources*[23].

The changing landscape of Italian financial markets and the integration of new theoretical perspectives have significantly influenced the perception and application of accounting policies. While the strategic use of discretion remains a critical aspect of earnings quality, the emphasis has shifted towards ensuring that this discretion does not undermine the reliability and comparability of financial statements. The contribution of Bruni (1975)[24] was crucial in this regard, as he argued that any form of manipulation of accounting numbers, even if legal, should be condemned if it leads to a distorted view of the firm's financial and economic situation. Cavalieri (1983)[25] was even more critical, highlighting that earnings management is never correct from an informational perspective and it is often illegal or a precursor to practices that exceed legality. Therefore, the reliability of accounting information assumes a central role in defining the quality of earnings. Specifically, the balance between the accuracy of accounting data and the use of accounting discretion aimed at increasing their informativeness is considered crucial for fostering investor confidence and promoting market stability.

In conclusion, the Italian doctrine has produced numerous contributions that have the merit of critically exploring the issue of earnings quality and its relation with the use of accounting discretion, highlighting both its benefits and its inherent risks of opportunistic behavior.

The following paragraph examines the definition adopted by the international doctrine. As will be seen, despite considerable efforts, defining a universally applicable concept of earnings quality remains a challenge. It constitutes also a challenge for researchers when attempting to measure the degree of earnings quality based on quantitative parameters.

However, when aiming for generalizability, it becomes clear that the concept of earnings quality cannot be separated from the context and the

(22) R. Poli, *Il bilancio d'esercizio,* Giuffè, Milano, 1971.
(23) W.R. Scott, *Financial Accounting Theory*, Prentice–Hall, Toronto, 2003.
(24) G. Bruni, 1975, *op.cit.*
(25) E. Cavalieri, 1983, *op.cit.*