FAMILY CONTROL AND EARNINGS QUALITY[1]

CONTROL FAMILIAR Y CALIDAD DEL RESULTADO

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RESUMEN

El trabajo analiza la relación entre el control familiar y la calidad de la información contable en un contexto en el que el tradicional conflicto de agencia entre directivos y accionistas se desplaza a la divergencia de intereses entre accionistas controladores y minoritarios. Los resultados alcanzados muestran que, en comparación con las no familiares, las empresas de naturaleza familiar divulgan unos resultados de mayor calidad, tanto en términos de menores ajustes por devengo discrecionales como de mayor capacidad de los componentes actuales del resultado para predecir los *cash flows* futuros. Además, el aumento en los derechos de voto en manos de la familia controladora incrementa la calidad de los resultados contables. La evidencia obtenida se muestra consistente con la presencia de un efecto reputación/vinculación a largo plazo asociado a la empresa familiar. Adicionalmente, el trabajo refleja que a medida que disminuye la divergencia entre los derechos de voto y de *cash flow* en manos de la familia controladora, aumenta la calidad de la información contable.

PALABRAS CLAVE: derechos de voto, divergencia, empresa familiar, calidad del resultado, reputación, beneficios privados.
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ABSTRACT

This work examines the relationship between family control and earnings quality in a context where the salient agency problem shifts away from the classical divergence between managers and shareholders to conflicts between the controlling owner and minority shareholders. The results reveal that, compared to non-family firms, family firms reveal higher earnings quality in terms of both lower discretionary accruals and greater predictability of future cash flows. They also show a positive relationship between the level of voting rights held by the controlling family and earnings quality. The evidence is consistent with the presence of a reputation/long-term involvement effect associated with the family firm. Moreover, the work reflects that, as the divergence between the voting and cash flow rights in the hands of the controlling family decreases, earnings quality increases.

KEY WORDS: voting rights, divergence, family firms, earnings quality, private benefits.

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1 INTRODUCTION

The objective of this work is to analyse the relationship between family control and earnings quality in a context where the traditional agency conflict between managers and shareholders is replaced by the divergence of the interests between controlling and minority shareholders. In that respect, in Anglo-Saxon countries, where outside investors are well-protected and the level of transparency is high, most listed firms present widely-held ownership structures. In this setting, the main agency conflict stems from the divergence of the interests between managers and shareholders (Jensen and Meckling, 1976). However, the ownership structure of listed Spanish firms, as in most countries of continental Europe, is characterised by high levels of concentrated ownership, by the use of pyramid structures that enable controlling shareholders to separate their voting and cash flow rights, and by the notable presence of family groups among such owners (*e.g.*, La Porta *et al.*, 1999; Faccio and Lang, 2002). Moreover, the control exerted by these family owners is not usually limited solely to their participation in the firm's ownership since they usually play an active role in management (La Porta *et al.*, 1999). In that regard, a lower separation between ownership and control shifts the main agency conflict to the possible expropriation of minority shareholders by controlling owners (*e.g.*, La Porta *et al.*, 2000; Faccio *et al.*, 2001 and Burkart *et al.*, 2003).

Thus, drawing on the literature to date, it is possible to address the relationship between family control and earnings quality from two opposing approaches. On the one hand, the highly concentrated ownership that usually characterises the family firm could lead the controlling family to use its position of power to take actions aimed at obtaining private benefits that could harm the interests of minority shareholders (*e.g.*, Morck *et al.*, 1988; La Porta *et al.*, 2000; Fan and Wong, 2002; Villalonga and Amit, 2006). This mainly occurs in a setting like Spain, where the interests of minority shareholders are poorly protected by the legal system. Furthermore, this expropriation of the minority shareholders' wealth could be exacerbated by the presence of pyramid structures that allow controlling owners to commit low equity investment while maintaining tight control of the firm (*e.g.*, Bebchuck, 1999; Fan and Wong, 2002). This kind of structure allows the controlling shareholders to escape the pro rata consequences of their decisions by creating a material difference between cash flow rights and voting rights (Francis *et al.*, 2005). Therefore, the desire to prevent greater scrutiny and so avoid possible sanctions derived from the detection of this behaviour could create incentives to alter the reported earnings (Warfield *et al.*, 1995). This leads the controlling family to report accounting information out of self-interest rather than as a reflection of the firm's underlying economic transactions.

Nevertheless, it could be pointed out that certain distinctive characteristics of the family firm, such as its long-investment horizons and its reputation concerns (Anderson and Reeb, 2003) would mean that the owners consider the firm as an asset to be passed on to their

descendants rather than wealth to be consumed during their lifetimes. Therefore, it could be argued that, compared with non-family, controlling family firms would tend to maximize the firm's wealth in the long term. Thus, there would be fewer incentives to obtain private benefits at the expense of minority shareholders, which in turn could result in higher earnings quality. In this sense, Wang (2006) and Ali *et al.* (2007) reveal a positive relationship between family ownership and earnings quality in a sample of U.S. firms. However, those authors also point out that one of the main limitations of their work is the difficulty to extend their results to other settings where there is a lower protection of minority shareholders, and consequently, more concentrated ownership structures.

In that respect and despite the significant proportion of capital that family owners manage in Europe, empirical evidence on the behaviour of family firms remains sparse (Maury, 2006). Therefore, this work analyses the impact of family control on earnings quality in a setting where the main agency problem stems from the conflict of controlling and minority shareholders' interests. In pursuit of that objective, we used a sample of Spanish firms listed in the period 1997-2003, as well as different measures of earnings quality such as the discretionary accruals and the predictability of cash flows.

This study extends previous research in several ways. Firstly, it contributes to the current debate on the importance of corporate governance mechanisms and particularly, ownership structure, as determinants of earnings quality. In this respect, it should be pointed out that the Spanish context offers the opportunity to undertake the study in a setting other than that considered in previous literature (*e.g.*, Wang, 2006; Ali *et al.*, 2007), since most listed firms in Spain, whether family firms or not, have concentrated ownership structures, which entails fewer demands for earnings quality (Ball *et al.*, 2003). Thus, in such a setting, the decision on the type of information disclosed and the way in which it should be communicated to third parties is to a great extent, conditional upon the controlling shareholders' utility function.

Secondly, this work uses the control chain methodology proposed by La Porta *et al.* (1999), Claessens *et al.* (2000) and Faccio and Lang (2002) to analyse ownership structure. The consideration of immediate ownership to analyse how control is exercised in an institutional setting in which complex ownership structures are used, as is the case in Continental Europe (*e.g.*, La Porta, *et al.*, 1999; Faccio and Lang, 2002; Haw, *et al.*, 2004), could lead to a dual error. On the one hand, a shareholder might be assigned a level of participation that does not match with the real one, and on the other hand, an agent who is not in the ultimate position of ownership might be identified as a shareholder with the ability to control. Furthermore, this methodology permits the analysis of the impact of the divergence between voting and cash flow rights in the hands of the controlling shareholder on earnings quality, an issue that has not been addressed in previous literature in the family business context. Moreover, since the control exercised by family owners is not usually limited to

mere participation in ownership, with such owners generally playing an active role in management (La Porta *et al.*, 1999), this work classifies a company as a family firm if the ultimate owner is a family or an individual whose rights are also represented on the board. This constitutes a notable difference in relation to previous works (*e.g.*, Wang, 2006; Ali, *et al.*, 2007) since, as Hutton (2007) indicates, the consideration of a firm as a family one in cases where the founder is an emeritus member of the board, or when the family does not hold a significant participation in the ownership is debatable.

The rest of the work is structured as follows. The second section addresses the theoretical approaches that justify the effect of family control on earnings quality. The third section describes the methodological issues of the empirical study. The results obtained are presented in Section 4 while the main conclusions of work are set out in the final section.

2 THEORETICAL FOUNDATIONS AND HYPOTHESES

Unlike firms in the Anglo-Saxon context, most firms in Continental Europe have concentrated ownership structures in which control is held by one, or very few, controlling shareholders (*e.g.*, La Porta *et al.*, 1999; Faccio and Lang, 2002). One of the factors that may explain the difference in ownership structures is the level of protection of minority shareholders[2] by the legal system. In this sense, Bebchuk (1999) suggests a greater presence of widely-held ownership structures in countries where the wealth of minority shareholders is well protected by the legal system (i.e., the United States, the United Kingdom). In that respect, Shleifer and Wolfenzon (2002) argue that, when there is stronger investor protection, capital markets are more developed and there is less ownership concentration. These theoretical arguments are in line with the empirical results obtained by La Porta *et al.* (1999), Claessens *et al.* (2000) and Faccio and Lang (2002).

Thus, ownership structure shapes the salient agency conflict in a specific institutional setting. In that regard, the presence of concentrated ownership shifts the classic agency problem away from the divergence of interests between managers and shareholders (*e.g.*, Jensen and Meckling, 1976; Fama, 1980; Fama and Jensen, 1983) to conficts between controlling and minority shareholders (*e.g.*, Shleifer and Vishny, 1997; La Porta *et al.*, 2000). The origin of this conflict can be found in the controlling shareholders' tendency to use their power to undertake activities aimed at obtaining private benefits that harm the minority shareholders' wealth. In addition, the presence of concentrated ownership is usually associated with the use of structures that permit the controlling shareholders to

(2) La Porta *et al.* (1998) analyze at an international setting the level of protection provided to external investors by the legal system. They distinguish two types of origins or legal families: *common law*, whose origins lie in Anglo-Saxon law, and *civil law*, based on the principles established by Roman law. Three families are observed in the latter: the French (including Spain), the German and the Scandinavian. This study reveals a higher level of protection in countries with legal systems of Anglo-Saxon origin, while *civil law* countries provide less protection, with the weakest protection of external investors found in legislations of French origin.

separate voting and cash flow rights (*e.g.*, La Porta et al., 1999; Francis *et al.*, 2005). This kind of structure allows the controlling shareholders to escape the pro rata consequences of their decisions by creating a material difference between their cash flow rights and voting rights (Francis *et al.*, 2005) all of which might exacerbate their tendency towards expropriation (*e.g.*, Morck *et al.*, 1998; Claessens *et al.*, 2000; Bebchuck *et al.*, 2000; Faccio *et al.*, 2001). Moreover, in countries like Spain, this incentive to obtain private benefits at the expense of minority shareholders might be accentuated since, unlike what occurs in Anglo-Saxon countries, the interests of minority shareholders are poorly protected by the legal system.

According to previous arguments, it could be argued that the greater concentration of voting rights could entail greater incentives for controlling shareholders to obtain private benefits. Furthermore, this trend could increase in the case of family firms since these private benefits remain with the controlling family whereas, in the case of firms whose ultimate owner is not a family (i.e., institutional), they are distributed among a great number of shareholders (Villalonga and Amit, 2006).

In that respect, some works have provided evidence on the expropriatory actions carried out by family groups. DeAngelo and DeAngelo (2000) illustrate how the controlling family of a large American firm cut dividends to minority shareholders while paying itself a special dividend. Similarly, drawing on data based on the entire population of Spanish newspapers Gómez *et al.* (2001) analyse the role that family relations play in agency contracts and provide evidence of the entrenchment of the Chairman of the board when he/she has family ties with the controlling shareholders. In those circumstances, controlling shareholders would have incentives to alter the accounting information in order to avoid the costs associated with the detection of this kind of behaviour (*e.g.*, Fan and Wong, 2002; Haw *et al.* 2004; Francis *et al.*, 2005; Santana *et al.* 2007). In that respect, Fan and Wong (2002) states that, when an owner effectively controls a firm, he/she also controls the production of the firm's accounting information and reporting policies. Therefore, based on the above arguments, one might predict that family control has a negative influence on earnings quality. Thus, we propose the following hypothesis:

Ha: Family control has a negative and significant effect on earnings quality.

However, another body of recent works has shown how certain distinctive characteristics of the family firm have a positive impact on corporate behaviour. More specifically, in their study of a sample of 500 North American firms between 1992 and 1999, Anderson *et al.* (2003) reveal that family firms achieve higher levels of performance than non-family firms. That result would be justified by certain characteristics associated with the family nature of the firm, such as as its long-investment horizons and its reputation concerns. In this sense, compared with other types of owner, families are interested in remaining in the firm

over a long period of time, so they are more prone to make investments that maximize value in the long term (*e.g.*, Stein, 1988; James, 1999; Casson, 1999; Chami, 2001; Anderson *et al.*, 2003). Thus, a family owner would tend to have incentives to follow market rules when making decisions since the firm is not considered a resource to be consumed during the owner's lifetime, but rather an asset to be transferred to his/her heirs in the future. Therefore, the firm's survival becomes a "family matter" in this type of enterprise. Furthermore, Anderson *et al.* (2003) suggest that the long-term ties typical of the family owner mean that external agents, such as suppliers or lenders, develop their businesses with the controlling family over a long period of time. This leads to those external agents perceiving a "family reputation" that has economic consequences that last not only for the founder's lifetime, but throughout the lives of his/her heirs.

On the same lines, Wang (2006) states that long-term orientation and reputation concerns means that family firms do not act opportunistically in reporting earnings since such actions are more in line with a short-term orientation. That author uses those arguments to offer possible explanations for the results obtained in his study using a sample of US firms and concludes that family firms provide better earnings quality than non-family firms. Ali *et al.* (2007) obtain similar results using alternative measures of earnings quality.

Based on these arguments, the distinctive characteristics of the family firm, such as concern for long-term survival or reputation, could result in a positive relationship between family control and earnings quality. Therefore, we propose an alternative hypothesis:

Hb: Family control has a positive and significant effect on earnings quality.

3 METHODOLOGICAL ISSUES

3.1. - Definition of the family firm

The works that examine the relationship between ownership structure and earnings quality have mainly focused on immediate ownership (*e.g.*, Carlson and Bathala, 1997; Chen and Jaggi, 2000; Chan and Gray, 2002; Gabrielsen *et al.*, 2002; Jung and Kwon, 2002; Chalmers and Godfrey, 2004). However, in the case of complex ownership structures, which are common in continental Europe, the use of immediate ownership does not accurately capture how the control of a firm is exercised (*e.g.*, La Porta *et al.*, 1999; Faccio and Lang, 2002; Haw *et al.*, 2004). In this work we use the control chain methodology proposed by La Porta *et al.* (1999), Claessens *et al.* (2000) and Faccio and Lang (2002). Thus, we consider a firm with an ultimate owner as a company where the principal shareholder directly or indirectly owns a percentage of voting rights that is equal to or above an established level of control, which in the case of those authors is 10% or 20%. In our case, the minimum cut-off level

is 10%. In that respect, La Porta *et al.* (1999) cites two reasons for the use of this percentage. Firstly, it is a significant level of voting rights, and secondly, firms in most countries are legally required to provide the market with information about the identity of shareholders holding 10% (or more) of the voting rights. However, although in 75% of the firms with an ultimate owner the level of that shareholder's voting rights exceeds 20%, the use of a 10% cut-off level best suits the Spanish context[3]. La Porta *et al.* (1999), Claessens *et al.* (2000) and Faccio and Lang (2002) consider that when the ultimate owner is either an individual or a family, the firm can be considered a family firm. This definition of a family firm has a clear advantage since it permits to attribute the company´s decisions to the controlling family. In this sense, Hutton (2007) indicates that the definition used by Ali *et al.* (2007), which considers a family firm as "any firm whose founders or descendants continue to hold positions in the top management or on the board, or are among the company´s largest shareholders" remains open to debate. Thus, according to this definition, a firm may be considered as a family one even under the assumption that a descendant of the founder holds a top management post but does not have any participation in the capital and so has no control over corporate decisions. The same disadvantages can be attributed to Wang's (2006) definition of family firms[4], as it refers to firms with substantial common stock held by family members or with founding family members actively involved in the management or the board of directors". Therefore, with the aim of ensuring that effective control of the decisions falls on the family, we have also added to the definition by La Porta *et al.* (1999), Claessens *et al.* (2000) and Faccio and Lang (2002) the requirement that the family's ownership is represented on the board.

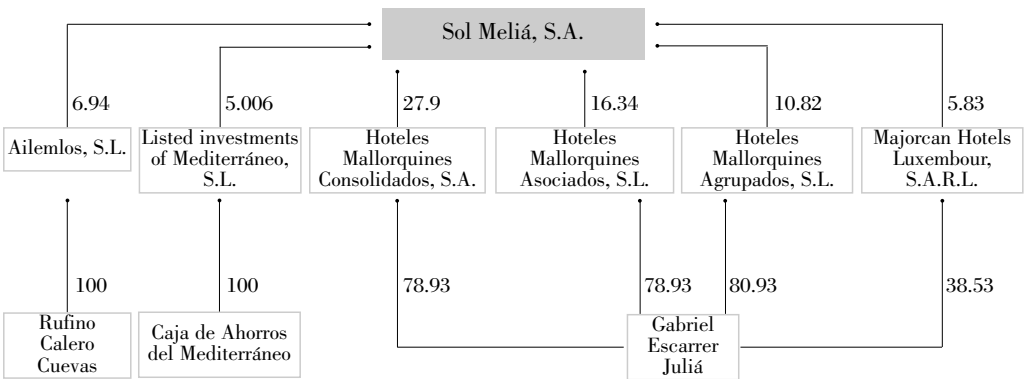
By way of example, if a family is the main shareholder of firm A, with 26% of its voting rights, and if firm A is the main shareholder of firm B, with 32% of the voting rights, we can state that firm B is controlled by the family with a level of control of 26%. This percentage would correspond to the weakest link in the control chain [min. (0.26; 0.32)], where the family is the ultimate owner by indirectly controlling firm B through firm A. Moreover, in this example, the family holds 8.32% of firm B's cash flow rights (the product of its holdings along the chain, 0.26x0.32). Thus, pyramid structures emerge when there is an ultimate owner that indirectly controls one firm through a participation in another firm. It can be seen that this kind of structures allow for the divergence between the ultimate owner´s voting and cash flow rights. If we consider that the family possesses 100% of firm A's voting rights, no divergence exists between voting and cash flow rights, since both rights amount to a percentage of 32%. On occasions, we find that a firm is controlled through a multiple control chain, that is, when the ultimate owner controls the firm via several control chains. Thus, if in the previous example the family directly owns 6% of firm B's voting rights, then this family holds 14,32% of the cash flow rights of firm B (0.26x0.32 + 0.06), and 32% of its voting rights, that is [min. (0.26; 0.32) + 0.06].

(3) However, we undertook an empirical study using 20% of the voting rights as the minimum cut-off level and the results remained unchanged.
(4) For a review of the definitions of family firm in the literature, consult the work of Cabrera and García (1999).

To determine the control chain using the previously explained methodology, the first step was to obtain information about large holdings from the National Stock Exchange Commission (Comisión Nacional del Mercado de Valores). From that information, we obtained the direct and indirect holdings of shareholders with more than 5% of shares, as well as the equity in the hands of directors irrespective of the size of the holding. The next step was to complement that source with the Informa database, which offered information on the ownership and the boards of directors of listed and unlisted Spanish firms. Those data were necessary to draw the firm´s entire control chain (that is, to identify the ultimate owner). In the case of a firm not being registered in Spain, we completed its ownership structure from the annual reports posted on the firm's website and when necessary we resolved any queries by e-mail.

Figure 1 shows the control chain of Sol Meliá on the 31st December 2006. We can see that Gabriel Escarrer Juliá is the company´s ultimate owner exercising his control through a pyramidal structure that enables him to hold 60.89% of the voting rights as opposed to 45.92% of the cash flow rights. Moreover, the voting rights of this ultimate owner are represented on the board. This firm, which would have mistakenly been classified as a non-family firm according to immediate ownership, is considered a family firm under the control chain methodology. In this work, we have determined the entire control chain of each firm and for each year considered in the final sample, without assuming that the levels of voting rights do not vary throughout that period.

FIGURE 1.- SOL MELIÁ CONTROL CHAIN AS AT 31st DECEMBER, 2003



3.2. - Measures of earnings quality

3.2.1. Earnings management

This work uses discretionary accruals as a proxy of earnings management. Specifically, it obtains total discretionary accruals using the cross sectional[4] discretionary acuals model suggested by Jones (1991) and modified by Dechow *et al.* (1995)[5] and Kothari *et al.* (2005)[6]. Thus, we first estimate the following regression model in cross section for each industry[7]-year combination.

$$ACC = a_0 + a_1(\Delta REV - \Delta AR) + a_2 PPE + a_3 ROA + \varepsilon \qquad \text{(Eq. 1)}$$

where ACC are total accruals, defined as change in non-cash current assets (from year t-1 to year t) minus the change in current liabilities, excluding the variation in financial debts, and minus amortization and depreciation expense. *DREV* is change in revenues. *DAR* is change in accounts receivables. *PPE* is the gross level of property, plant and equipment *ROA* is return of assets ratio. All the variables are deflated by the value of total assets at the beginning of the year[8].

The absolute value of the residuals of regression for each firm-year observation is the measure of discretionary accruals. Thus, a low value of discretionary accruals will indicate high quality of reported earnings. The use of unsigned discretionary accruals is justified by the absence of a specific theoretical prediction regarding their positive or negative values (Monterrey and Sánchez-Segura, 2007). Like those authors, we agree with Warfield *et al.* (1995) when they indicate that the absolute value of discretionary accruals determines the extent to which the management intentionally applies certain techniques to adjust reported figures.

Thus, to verify the relationship between family control and earnings management, we move on to the estimation of the following regression model:

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(4) The cross-sectional estimation of discretionary accrual has been used in recent literature on earnings management (*e.g.*, Gaver *et al.*, 1995; Becker *et al.*; 1998; DeFond and Subramanyam, 1998; Teoh *et al.*, 1998a, 1998b; Beneish, 1997; Peasnell *et al.*, 2000; García and Gill, 2007; Monterrey and Sánchez-Segura, 2007).

(5) The modification by Dechow *et al.* (1995) came about from the consideration that the Jones model assumes that revenues are non-discretionary; thus, if earnings are managed through discretionary revenues, then the Jones model will remove part of the managed earnings from the discretionary accrual proxy. In this way, the model modified by Dechow *et al.* (1995) considers that, in obtaining discretionary accruals, the entire variation in credit sales is due to earnings management.

(6) The modification by Kothari *et al.* (2005) includes the ROA variable in the accrual model, which mitigates specification errors (indicated by Dechow *et al.*, 1995) in firms displaying extreme values for return of assets ratio.

(7) The following industries have been identified from the National Stock Exchange Commission classification: Oil and Energy, Basic Materials, Manufacturing Industries and Construction, Consumer Goods, Consumer Services, Real Estate, and finally, Telecommunication and New Market. A minimum of six observations were required for each sector and year, which is in line with DeFond and Jiambalvo (1994), Young (1999) and García and Gill (2007).

(8) With the exception of *ROA*, which by definition is deflated by the total assets at the beginning of the year.

$$AbDACC = \alpha_0 + \beta_1 OWN + \beta_2 FAMVAR + \beta_3 AGE + \beta_4 SIZE + \beta_5 LEV + \\ + \beta_6 MTB + \beta_7 INST + \beta_8 ROA + \beta_9 LOSS + \beta_{10} CFO + \\ + \sum_{j=1}^{7} \beta_j YEAR_t + \sum_{h=1}^{7} \beta_h IND_t + \varepsilon \quad \text{(Eq. 2)}$$

where *AbDACC* represents the absolute value of discretionary accruals and *FAMVAR* reflects the effect of family control, measured in the following ways. The first is by means of a dummy variable *FAM*, which takes a value of 1 when the firm is a family firm and 0 otherwise. The second is through the continuous variable *FAMOWN*, which represents the percentage of voting rights held by the ultimate owner when that owner has a family nature. Finally, as an extension of the analysis of family control, we examine whether the divergence between the controlling family's voting and cash flow rights has a negative impact on earnings quality. To that end, we consider the variable *FAMDIV*, measured as the ratio of the controlling family's voting rights to cash flow rights. By mere definition of the ratio, *FAMDIV* is inversely related to the level of divergence between the voting and cash flow rights in the hands of the controlling family.

Furthermore, a set of control variables used in earlier literature has been included in the model. Thus, *OWN* represents the percentage of voting rights in the hands of the ultimate owner, *LEV* captures the effect of debt by means of the relationship between the book value of the financial debt to total assets at the beginning of the year, *SIZE* represents the size effect as the logarithm of operating revenue at the beginning of the year, *ROA* is return of assets ratio, *MTB* reflects the effect of growth opportunities by means of the market-to-book ratio, *INST* captures the effect of the control exercised by institutional investors as the percentage of the voting rights held by those shareholders, *LOSS* is a dummy variable with a value of 1 if the firm reports losses and 0 otherwise and is included to reflect the effect of the risk of insolvency, *AGE* is the effect of the firm's age, $YEAR_t$ is a dummy variable controlling for year effects. IND_i is a dummy variable controlling for industry effects.

3.2.2. Predictability of cash flows

In order to obtain the measure related to the ability of the components of current earnings to predict future cash flows, we followed the methodology applied by Dechow *et al.* (1998), Barth *et al.* (2001), Cohen (2004) and Ali *et al.* (2007). More exactly, we use the residuals obtained from the following regression of future cash flows from operations on prior period's earnings components[9]:

$$CFO_{it+1} = \alpha_0 + \alpha_1 CFO_{it} + \alpha_2 DT_{it} + \varepsilon \quad \text{(Eq. 3)}$$

(9) We have chosen not to provide a breakdown of the total accruals (ACC) in the variables (Ali et al., 2007) since we are solely interested in regression residuals.

where *CFO* is the cash flow from operations, measured as the difference between earnings and the total accruals, deflated by total assets at the beginning of the year.

As in the case of discretionary accruals, the regression is estimated for each industry-year combination. The absolute value of the residuals obtained (*AbPC*) is the measure of reporting quality. These residuals reflect the amount of future cash flows from operations that are not related to current components of earnings. Thus, the lower absolute values of this variable, the greater the ability of the current components of earnings to predict future cash flows (higher quality).

The relationship between family control and predictability of cash flows will be tested with the following logistic regression model:

$$QUALITY = \alpha_0 + \beta_1 OWN + \beta_2 FAMVAR + \beta_3 AGE + \beta_4 SIZE + \beta_5 LEV + \\ + \beta_6 MTB + \beta_7 INST + \beta_8 ROA + \beta_9 LOSS + \beta_{10} CFO + \\ + \sum_{t=1}^{7} \beta_j YEAR_t + \sum_{t=1}^{7} \beta_h IND_t + \varepsilon \qquad \text{(Eq. 4)}$$

where *QUALITY* is a dummy variable that takes the value of 1 if *AbPC* is less than the median value of *AbPC*, and 0 otherwise.

3.3. - Sample selection

The sample was selected from 111 non financial firms listed on the Spanish stock market at the end of 2003. Six firms were eliminated from the final sample since they were not registered in Spain and one company was also excluded since trading was suspended due to a liquidation process. Two additional firms were not considered since they did not provide at least 3 observations during the period 1997-2003. After identifying the control chain of the remaining 102 firms for the seven years under study, twelve firms with no ultimate owner[10] were eliminated.

(10) By eliminating those firms with widely-held ownership, the final sample comprises only those firms in which there is an ultimate owner (family or non-family). Thus, we will obtain more robust results since the agency conflict between majority and minority shareholders will predominate in all the firms, and this is one of the central points of this work. However, the results would not be significant changed if the 102 firms are contemplated.

4 RESULTS

4.1. Descriptive analysis

With regard to the family nature of the ultimate owner, Table 1 displays the weighting of family firms during the period 1997-2003. It shows that, in 2003, 41.11% of the analysed listed firms were controlled by family groups. These results are in line with the theoretical approaches found in the works of Bebchuck (1999) and Burkart *et al.* (2003), and also with the empirical results of the studies by La Porta *et al.* (1999) and Faccio and Lang (2002).

TABLE 1.- PERCENTAGE DISTRIBUTION OF THE FAMILY NATURE OF THE CONTROLLING SHAREHOLDERS

	1997	1998	1999	2000	2001	2002	2003
Family firms	47.37	40.00	42.67	44.58	44.94	41.11	41.11
Non-family firms	52.63	60.00	57.33	55.42	55.06	58.89	58.89
Total number of firms	57	65	75	83	89	90	90

A firm is defined as a family firm when the ultimate owner is a family or an individual and their voting rights are represented on the board.
The sample comprises 90 non-financial Spanish firms listed between 1997 and 2003.

The descriptive statistics, together with the correlation matrix of the variables, are presented in Table 2. This table shows that the level of concentration of voting rights in the hands of the controlling family (42.69%) exceeds the average for the total number of firms irrespective of the controlling owner's nature (38%). Furthermore, it can be seen that family firms separate their voting and cash flow rights through the use of pyramid structures, since the average of the variable *FAMDIV* obtains a value of 0.901. On the other hand, the presence of institutional ownership among the firms analyzed is notable since the average value of the variable *INST* is approximately 13% of the voting rights in the hands of institutional investors. Moreover, we should stress that most firms do not report losses since the variable *LOSS* has an average value of 0.06 and a median of zero. Finally, and with regard to the data reflected in the correlation matrix, we did not observe high correlation values between the explanatory variables; this enables us to state that the existence of multicolinearity problems in the specification of the regression models is improbable.

TABLE 2.- DESCRIPTIVE STATISTICS AND CORRELATION MATRIX

Descriptive statistics														
	AbDACC	QUALITY	OWN	FAMDIV	FAM	FAMOWN	MTB	LEV	SIZE	ROA	INST	LOSS	AGE	CFO
Average	0.057	0.47	38.02	0.901	0.558	42.69	2.82	0.65	12.99	0.075	13.95	0.06	40	0.08
Median	0.038	0	34.29	1	1	40.89	1.68	0.59	12.90	0.065	8.825	0	33	0.08
Deviation	0.057	0.49	21.57	0.197	0.497	19.92	4.90	0.48	1.62	0.094	16.02	0.24	26.3	0.11
Minimum	0.0004	0	10.02	0.28	0	10.46	0.27	0.08	9.38	-0.273	0	0	2	-0.22
Maximum	0.285	1	93	1	1	91.63	22.23	1.89	16.31	0.387	61.85	1	100	0.45

Correlation matrix														
	AbDACC	QUALITY	OWN	FAMDIV	FAM	FAMOWN	MTB	LEV	SIZE	ROA	INST	LOSS	AGE	CFO
AbDACC	1													
QUALITY	0.30	1												
OWN	0.01	-0.01	1											
FAMDIV	0.06	-0.005	0.05	1										
FAM	-0.01	-0.01	0.29	0.03	1									
FAMOWN	-0.04	-0.03	0.62	0.05	0.82	1								
MTB	0.14	0.10	0.07	0.003	-0.07	-0.05	1							
LEV	0.18	0.06	0.12	0.06	0.12	0.109	0.05	1						
SIZE	-0.15	-0.20	0.04	-0.13	-0.30	-0.17	0.03	0.06	1					
ROA	-0.02	0.13	-0.01	-0.05	-0.08	-0.06	0.32	0.09	0.005	1				
INST	0.009	-0.04	-0.32	0.03	-0.50	-0.50	-0.07	0.04	0.13	0.04	1			
LOSS	0.06	-0.009	0.14	0.03	0.09	0.15	-0.004	-0.02	-0.09	-0.53	-0.18	1		
AGE	-0.08	-0.02	-0.08	-0.009	-0.04	-0.02	-0.07	0.06	0.26	-0.02	0.23	-0.06	1	
CFO	-0.10	0.03	0.05	-0.01	-0.04	-0.03	0.27	0.19	0.03	0.40	-0.08	-0.10	-0.13	1

Definition of variables:
AbDACC, the absolute value of discretionary accruals. FAM, a dummy variable that takes the value of 1 when the firm is a family firm, and 0 otherwise. QUALITY, a dummy variable whose value is 1 when AbPC is below the median, and 0 otherwise (AbPC is the measure of future cash flows that are not related to the components of earnings of the current year). FAMOWN, is the percentage of voting rights in the hands of the controlling family. FAMDIV, is the divergence between the voting and cash flow rights in the hands of the controlling family. OWN, represents the percentage of voting rights held by the ultimate owner. LOSS, is the dummy variable with a value of 1 if the firm has reported losses, and 0 otherwise. CFO, is cash flow from operations, measured as the difference between earnings before extraordinary items and the total accruals, deflated by total assets at the beginning of the year. AGE, is the firm's age. MTB, is the market-to-book ratio. LEV, is the relationship between the book value of the financial debt and total assets at the beginning of the year. SIZE, is the natural logarithm of revenues at the beginning of the year. ROA, is the return on assets. INST, is the percentage of voting rights held by institutional shareholders. YEARt is a dummy variable controlling for year effects. INDi is a dummy variable controlling for industry effects.
The sample comprises 90 non financial Spanish firms listed between 1997 and 2003.

4.2. Family control and earnings quality

To analyse the incidence of family control on the level of discretionary accruals, we perform a set of ordinary least squares regressions. To avoid the possible influence of extreme values, we have eliminated those observations for which *studentized* residuals of the estimated equations exceeded an absolute value of 2. The statistical significance of the coefficients is based on the Huber-White covariance matrix, which is robust for heteroskedasticity.

The estimated regressions of Equation 2 (Eq. 2) using ordinary least squares correspond to Models 1, 2 and 3. In Model 1, we include an attribute of family control, a dummy variable that measures the family nature of the ultimate owner (*FAM*), and in Model 2 we consider another dimension of family control, a continuous variable that reflects that ultimate owner's voting rights (*FAMOWN*). Moreover, the variable *FAMDIV* has been included in Model 3 in order to analyse the impact of the divergence between the controlling family's voting and cash flow rights on discretionary accruals. In Model 1, the significant negative coefficient on the variable *FAM* is consistent with family firms using a lower level of discretionary accruals compared to non-family firms. Besides this, the coefficient on the variable *FAMOWN* in Model 2 is also negative and statistically significant, which suggests that the higher the percentage of voting rights in the hands of the controlling family, the lower the level of discretionary accruals. Furthermore, the coefficient on the variable *FAMDIV* is not statistically significant in Model 3.

TABLE 3.- FAMILY CONTROL AND EARNINGS QUALITY.

	AbDACC			QUALITY		
	(1)	(2)	(3)	(4)	(5)	(6)
FAM	-0.012*			0.930***		
	(-1.76)			(2.95)		
FAMOWN		-0.0002*			0.016**	
		(-1.68)			(2.44)	
FAMDIV			-0.009			0.896***
			(-1.22)			(2.76)
OWN	-0.009	0.0001	-0.0002	0.006	-0.001	0.006
	(-0.08)	(0.74)	(-0.18)	(1.15)	(-0.23)	(1.19)
LOSS	0.001	0.003	0.001	-0.439	-0.59	-0.42
	(0.13)	(0.30)	(0.14)	(-0.87)	(-1.17)	(-0.84)
CFO	0.001	-0.002	0.002	-2.23	-2.06	-2.24
	(0.04)	(-0.09)	(0.07)	(-1.57)	(-1.45)	(-1.58)
AGE	0.0001	0.0009	-0.0001	-0.010*	-0.01**	-0.009*
	(0.02)	(0.09)	(-0.11)	(-2.03)	(-2.06)	(-1.88)
MTB	0.002**	0.002**	0.002**	-0.0001	0.001	-0.002
	(2.24)	(2.21)	(2.32)	(0.05)	(0.04)	(-0.06)
LEV	0.017*	0.016*	0.015*	-0.606	-0.55	-0.598
	(1.83)	(1.78)	(1.68)	(-1.36)	(-1.23)	(-1.33)
SIZE	-0.006***	-0.006***	0.006***	0.149*	0.114	0.153*
	(-3.05)	(-2.92)	(-2.92)	(1.73)	(1.36)	(1.76)
ROA	0.008	0.014	0.010	-2.27	-2.75	-2.23
	(0.19)	(0.30)	(0.21)	(-1.13)	(-1.38)	(-1.11)
INST	-0.0007	-0.0004	-0.0001	0.012	0.008	0.011
	(-0.37)	(-1.29)	(-0.07)	(1.33)	(0.95)	(1.18)
Industry effect	Yes	Yes	Yes	Yes	Yes	Yes
Year effect	Yes	Yes	Yes	Yes	Yes	Yes
Constant	0.096***	0.098***	0.093***	1.243	2.12	(1.51)
	(2.96)	(3.12)	(2.83)	(0.86)	1.14	(0.79)
R^2 adjusted	0.13	0.13	0.13			
F	3.86***	3.85***	3.76***			
Wald Test				79.75***	76.82***	78.58***
Log likelihood				-231.83	-233.29	-232.42
Pseudo R^2				0.14	0.14	0.14

AbDACC, the absolute value of discretionary accruals. FAM, a dummy variable that takes the value of 1 when the firm is a family firm, and 0 otherwise. QUALITY, a dummy variable whose value is 1 when AbPC is below the median, and 0 otherwise (AbPC is the measure of future cash flows that are not related to the components of earnings of the current year). FAMOWN, is the percentage of voting rights in the hands of the controlling family. FAMDIV, is the divergence between the voting and cash flow rights in the hands of the controlling family. OWN, represents the percentage of voting rights held by the ultimate owner. LOSS, is the dummy variable with a value of 1 if the firm has reported losses, and 0 otherwise. CFO, is cash flow from operations, measured as the difference between earnings before extraordinary items and the total accruals, deflated by total assets at the beginning of the year. AGE, is the firm's age. MTB, is the market-to-book ratio. LEV, is the relationship between the book value of the financial debt and total assets at the beginning of the year. SIZE, is the natural logarithm of revenues at the beginning of the year. ROA, is the return on assets. INST, is the percentage of voting rights held by institutional shareholders. YEARt is a dummy variable controlling for year effects. INDi is a dummy variable controlling for industry effects.
The sample comprises 90 non financial Spanish firms listed between 1997 and 2003.
***,**,*: Statistically significant at 1, 5 and 10 per cent respectively.
In parentheses, t-statistics based on robust standard errors clustered by firm.

To analyse further the incidence of family control on the second dimension of earnings quality considered in the study, predictability of cash flows, we perform a set of ordinary least squares regressions. The estimated regressions of Equation 4 (Eq. 4) using ordinary least squares correspond to Models 4, 5 and 6. In Model 4, the coefficient on the variable *FAM* is positive and significant, showing a greater ability of the components of current earnings to predict future cash flows in family firms than in non-family firms. As Model 5 shows predictability of cash flows will also increase as the controlling family's percentage of voting rights increases since the coefficient on the variable *FAMOWN* is positive and statistically significant. Therefore, the results support Hypothesis *Ha*, which proposes that family control has a positive impact on earnings quality. Finally, in Model 6 the coefficient on the variable *FAMDIV* is positive and statistically significant. This result implies an increase in earnings predictability as the divergence between the controlling family's voting and cash flow rights decreases, since in this setting the controlling family's incentives to obtain private benefits will be reduced.

With regard to the coefficients on the control variables we must point out that when they are statistically significant, their signs are consistent with previous literature (*e.g.*, Becker *et al.*, 1998; Chung and Kallapur, 2003; Wang, 2006; Ali *et al.*, 2007). Thus, the market-to-book ratio (*MTB*) and debt (*LEV*) have a positive impact on the level of discretionary accruals, while size (*SIZE*) has a negative incidence.

Robustness

In order to check the robustness of the results, several alternative tests were carried out. First of all, we use a less restrictive definition of a family firm. In that respect, we adopt the definition by La Porta *et al.* (1999), Claessens *et al.* (2000) and Faccio and Lang (2002), who consider a family firm a company in which the ultimate owner is an individual or family, with no requirement for that ownership to be represented on the board. Using this new definition, we redefine the variables that are the object of the empirical test and label them *FAMbis*, *FAMOWNbis* and *FAMDIVbis*. As the various models show (Table 4), the results are consistent with those previously obtained. Therefore, they are not sensitive to the alternative definition of a family firm. Moreover, in this case, a statistically significant coefficient is obtained for variable *FAMDIVbis* in Models 9 and 12.

Finally, we have run regressions to assess the effect of controlling family on the predictability of cash flows using the continuous variable *AbPC*, instead of the dummy variable *QUALITY*. In this way, the estimated regressions considered the two alternative definitions of a family firm. The results do not differ from those previously obtained.

TABLE 4.- FAMILY CONTROL AND EARNINGS QUALITY. ROBUSTNESS

	AbDACC			QUALITY		
	(7)	(8)	(9)	(10)	(11)	(12)
FAMbis	-0.016**			0.915***		
	(-2.32)			(2.92)		
FAMOWNbis		-0.0003*			0.016**	
		(-1.86)			(2.41)	
FAMDIVbis			-0.01*			0.820**
			(-1.68)			(2.56)
OWN	-0.005	0.0001	-0.0001	0.007	-0.001	0.007
	(-0.04)	(0.84)	(-0.15)	(1.24)	(-0.20)	(1.28)
LOSS	0.008	0.003	0.001	-0.41	-0.58	-0.42
	(0.07)	(0.30)	(0.09)	(-0.82)	(-1.16)	(-0.84)
CFO	-0.008	-0.004	0.0007	-2.18	-2.04	-2.21
	(-0.03)	(-0.13)	(0.02)	(-1.54)	(-1.44)	(-1.56)
AGE	0.0001	0.0001	-0.0005	-0.01**	-0.01**	-0.01*
	(0.13)	(0.13)	(-0.05)	(-2.09)	(-2.07)	(-1.91)
MTB	0.002**	0.002**	0.002**	-0.0005	0.001	-0.002
	(2.19)	(2.19)	(2.30)	(-0.05)	(0.04)	(-0.05)
LEV	0.018*	0.017*	0.016*	-0.58	-0.54	-0.56
	(1.96)	(1.83)	(1.77)	(-1.32)	(-1.21)	(-1.25)
SIZE	-0.006***	-0.006***	-0.006***	0.152*	0.115	0.150*
	(-3.22)	(-2.95)	(-3.04)	(1.75)	(1.37)	(1.72)
ROA	0.004	0.013	0.007	-2.20	-2.73	-2.22
	(0.11)	(0.29)	(0.15)	(-1.09)	(-1.37)	(-1.11)
INST	-0.0001	-0.0005	-0.0003	0.011	0.008	0.009
	(-0.55)	(-0.27)	(-0.17)	(1.22)	(0.91)	(1.00)
Industry effect	Yes	Yes	Yes	Yes	Yes	Yes
Year effect	Yes	Yes	Yes	Yes	Yes	Yes
Constant	0.101***	0.085***	0.097***	1.218	2.49*	1.21
	(3.13)	(2.72)	(2.95)	(0.84)	(1.78)	(0.84)
R^2 adjusted	0.14	0.13	0.13			
F	4.00***	3.88***	3.83***			
Wald test				79.57***	76.67***	77.45***
Log likelihood				-231.92	-233.37	-232.98
Pseudo R^2				0.14	0.14	0.14

AbDACC, the absolute value of discretionary accruals. *FAM*, a dummy variable that takes the value of 1 when the firm is a family firm, and 0 otherwise. *AbPC*, is the measure of future cash flows that are not related to the components of earnings of the current year. *FAMOWN*, is the percentage of voting rights in the hands of the controlling owner. *FAMDIV*, is the divergence between the voting and cash flow rights in the hands of the controlling family. *OWN*, represents the percentage of voting rights held by the ultimate owner. *LOSS*, is the dummy variable with a value of 1 if the firm has reported losses, and 0 otherwise. *CFO*, is cash flow from operations, measured as the difference between earnings before extraordinary items and the total accruals, deflated by total assets at the beginning of the year. *AGE*, is the firm's age. *MTB*, is the market-to-book ratio. *LEV*, is the relationship between the book value of the financial debt and total assets at the beginning of the year. *SIZE*, is the natural logarithm of revenues at the beginning of the year. *ROA*, is the return on assets. *INST*, is the percentage of voting rights held by institutional shareholders. *YEARt* is a dummy variable controlling for year effects. *INDi* is a dummy variable controlling for industry effects.
***,**,*: Statistically significant at 1, 5 and 10 per cent respectively.
In parentheses, t-statistics based on robust standard errors clustered by firm.

5 CONCLUSIONS

This work shows that the family nature of the ultimate owner affects earnings quality in a context where the salient agency conflict is the expropriation of minority shareholders by controlling owners. In such a setting, the interests of external investors are scarcely protected by the legal system, and the ownership structure is characterized by a high concentration of voting rights in the hands of the controlling family, but also by the use of structures that enable this kind of shareholder to separate voting and cash flow rights.

The study shows that the family nature of the controlling shareholder entails lower levels of discretional accruals, and greater cash flows predictability. Furthermore, the controlling family's level of voting rights has a positive impact on earnings quality. These results are robust to the use of the different definitions of the family firm and consistent with the long-investment horizons of family firms. This means that family firms are conceived as an asset to be transferred to the heirs, rather than wealth to be consumed during the owner's lifetime. The evidence is in line with that obtained for US firms by Wang (2006) and Ali *et al.* (2007). Thus, the impact of the positive features of family control on earnings quality seems to persist in a context where a few shareholders concentrate a high proportion of voting rights.

The results of this work also show that, in a family-controlled firm, the divergence between the ultimate owner´s voting and cash flow rights through the use of pyramid structures increases the incentives of the controlling family to obtain private benefits at the expense of the minority shareholder. This fact creates incentives for the controlling family to alter accounting numbers in order to avoid close monitoring by outsiders, all which implies a reduction in earnings quality. So the negative effect usually found in previous literature regarding the divergence between the ultimate shareholder´s voting and cash flow rights also extends to family firms.

Finally, at a time when Spanish accounting regulations are undergoing changes, the results obtained in this study are of special importance since they clearly show the need to consider the incentives associated with the nature of the controlling shareholders as important determinants of accounting quality. We also consider that the results obtained may be extended to other countries of continental Europe, where the paradigm of corporate governance is similar to that in Spain.

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