

## EARNING QUALITY IN LISTED FIRMS: HOW MUCH AN ACTIVE FAMILY GOVERNANCE IS DESIRABLE?

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### Abstract

The study investigates the relationship between family involvement in the governance of Italian listed companies and earnings quality (EQ). Family firms set incentives to extract private benefits ('entrenchment' effect), but, they also contribute to higher alignment between owners and managers ('alignment' effect). The literature shows mixed results about the relationship between EQ and family firms. We argue that family involvement in the governance affects EQ. The empirical evidence shows that in the Italian context, there is higher EQ in case of higher family involvement in the board, but only if the CEO is not belonging to the controlling family. On the contrary, in case of a family CEO, the higher family involvement in the board increases his entrenchment, reducing EQ. The results are valuable because we find that EQ in family firms is affected both by family ownership and by the attitude of the family toward governance practices.

**Keywords:** Family Firms, Board Familiness, Governance Practices, Earnings Quality, Alignment Effect, Entrenchment Effect

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### Introduction

This study aims at contributing to the increasing stream of literature on the economic efficiency of listed family companies under the perspective of information transparency, with a focus on the relation between earnings quality, family involvement and corporate governance practices.

Accounting practices pursued by family firms remain particularly under-explored (Salvato and Moores, 2010). Moreover, the studies about the topic don't obtain unanimous results. It is a diffused common thinking that listed family firms are less transparent than publicly held companies, due to excessive power of controlling shareholders and ineffective monitoring systems counterbalancing it (Bebchuk et al., 1998; Fama & Jensen 1983; Morck et al., 1998, Shleifer & Vishny, 1997; Schulze, Lubatkin, Dino and Buchholtz, 2001; Fan & Wong, 2002; Francis et al., 2005). It is due to the so-called "entrenchment effect": concentrated ownership creates incentives for controlling shareholders to expropriate wealth from other shareholders and to manipulate earnings for private rents (Fama & Jensen, 1983; Morck et al., 1988; Shleifer & Vishny, 1997).

On the other hand, family firms benefit from the natural alignment between management and shareholders' interests, sharing the common purpose of creating value in the long run. And even if a non family-member is acting as CEO, the controlling

family monitors management more effectively than in large public companies (Demsetz & Lehn, 1985; Shleifer & Vishny, 1986). Families have higher incentives to report good earnings quality for preserving their reputation for future generations and for long-term profitability (Weber et al., 2003). This is the so-called "alignment effect": the interests of families and other shareholders are aligned thanks to their long-term orientation. In this perspective, family firms are likely to report earnings of higher quality than non-family firms (Wang, 2006). In spite of the existing literature gap on the relationship between earnings quality (hereinafter also EQ), "familiness" and corporate governance practices, the topic is also relevant in order to better explain the agency problems affecting family firms.

In particular, family-controlled companies face less severe Type I agency problems arising from the separation between ownership and control but have higher Type II agency problems characterizing the relationship between controlling and non-controlling shareholders (Jensen and Meckling, 1976; Gilson and Gordon, 2003). These problems affect the quality of reported earnings.

In particular, the paper discusses if and how governance practices affect earnings quality. We argue that higher family involvement in the board leads to more effective monitoring activities and thus to higher EQ (alignment effect prevailing), but only when the CEO is not a member of the family.

On the contrary, if the family dominates the board together with a family CEO there are stronger incentives to extract private benefits with lower information transparency (entrenchment effect prevailing). The findings support our hypotheses.

The empirical analysis is performed through a sample of Italian listed companies, highly characterized by family capitalism.

Our results are valuable because they underline that EQ in family firms is not only affected by family ownership, but mainly by family involvement in governance practices, and in particular by CEO role. Moreover, these results could be useful both for financial statements users, suggesting that company's ownership structure and its corporate governance practices should be considered when using accounting data, and for policy makers in defining corporate governance incentives.

The paper is structured as follows. Firstly, the literature on EQ and family firms is reviewed. Then, the research hypothesis is developed. A following section explains the methodology of the analysis. The presentation of empirical results, their discussion and the conclusions close the article.

## Literature Review

### *Family Firms and agency costs*

Family firms represent a typical example of ownership concentration, controlled either by an individual or by a family. Family companies face less severe Type I agency problems (Berle & Means, 1932; Jensen & Meckling, 1976; Roe, 1994), especially when the leaders are either family members or linked to the family (Bertrand & Schoar, 2006; Miller & Le Breton-Miller, 2006), with alignment effect prevailing (Wang, 2006). But, on the other hand, they are more characterized by severe Type II agency problems (Gilson and Gordon, 2003; Shleifer & Vishny, 1997; La Porta et al., 1999), with a prevalence of the entrenchment effect (Wang, 2006). Prior studies suggest that minorities expropriation is likely to be more severe when the controlling shareholders are also managers and when countries' legal protection and enforcement of securities law are poor (La Porta et al., 1999).

Literature does not come to unique results about the economic efficiency and performance of family firms. Some authors, in fact, found that increasing the controlling shareholders' ownership it is possible to enhance the alignment of interests between them and minority shareholders (Fan & Wong, 2002; Fahlebrach, 2004; Gomes, 2000; Morck et al., 1988; Palia & Ravid, 2002; Shleifer and Vishny, 1986). Some other authors, instead, found that the stock market reacts negatively to the appointment of family heirs as managers (Smith and Amoako-Adu, 1999; Perez-González, 2001).

### *Family firms and the board of directors*

The board of directors (BoD) is considered a mechanism insuring that management acts in the interests of shareholders (Shleifer and Vishny, 1997).

In case of dispersed ownership, the BoD could minimize agency problems (Fama and Jensen, 1983), always retaining ultimate control (Beasley, 1996), because its main role is to advise and support the management (Corbetta and Salvato, 2004b),

But in case of concentrated ownership, such as family firms, studies about family role in the BoD do not provide unique results.

On the one hand, in fact, family controlling owner can directly monitor the managers (Anderson & Reeb, 2003b; Demsetz & Lehn, 1985; Shleifer & Vishny, 1997; Luoma & Goodstein, 1999; Sundaramurthy & Lewis, 2003) having much longer investment horizons compared to other shareholders and helping in mitigating myopic investment decisions by managers (James, 1999, Kwak, 2003, Stein, 1989), consistently with the "alignment effect" of family ownership (Wang, 2006). Furthermore, families have incentives to create long-term employees loyalty (Weber et al., 2003). Firms with a relatively high level of goal alignment are even less likely to have a board of directors (Pieper et al., 2008; Jaskiewicz & Klein, 2007).

On the other hand, family members operating both as managers and as directors tend to dominate and extract private benefits (Anderson & Reeb, 2003a; Anderson & Reeb, 2004; Gilson & Gordon, 2003; Shleifer & Vishny, 1997). Thus, these firms may have inferior corporate governance and lower accountability because of ineffective monitoring by the board, which often simply ratifies the decisions taken by the majority shareholders. This is consistent with the "entrenchment effect" of family ownership (Wang, 2006).

Another controversial issue is CEO role inside the BoD. CEO often ends up controlling the composition of the board and lessening its monitoring role (Jensen, 1993; Hermalin and Weisbach, 1991). In this perspective, boards evolve over time as a function of the bargaining power of the CEO, and managers tend to reduce this power as their equity ownership increases resulting in a weak relationship between board structure and firm value (eDenis and Sarin, 1999; Hermalin and Weisbach, 1991; Mikkelsen and Partch, 1997; Weisbach, 1988). Empirical evidence shows that family ownership creates value for all shareholders only when the founder is still active as CEO, while, in the firms run by descendent CEO, minority shareholders are worse than they could be in non family firms (Villalonga and Amit, 2006).

### **Family firms and the effect on earnings quality**

Ownership structure affects the supply of financial reporting (Fan and Wong, 2002), together with corporate governance practices.

Prior research focusing on this relationship argues that high levels of ownership concentration may increase or reduce earnings informativeness depending on whether incentive effects or information effects dominate (Francis, Schipper, and Vincent, 2005), so that accounting earnings have a double role. In case of dispersed ownership, high levels of managerial ownership enhance earnings informativeness by aligning managers' interests with shareholders' (Warfield et al., 1995; Bushman and Smith, 2001; Christie and Zimmerman, 1994; Watts and Zimmerman, 1986). But, Fan and Wong (2002) argue that managers can use earnings management to maximize private benefits at the expense of other stakeholders.

Also in case of concentrated ownership, such as family firms, accounting earnings can have a double role. When the owner/family effectively controls a company he also controls accounting information even if the company is managed by non-family managers. In this case the reliability of firm's accounting information is reduced. Outside investors expect that the controlling owner reports accounting information more for outright expropriation than to reflect firm's true underlying economic situation (Fan & Wong, 2002), even through fraudulent accounting behaviors (Tiscini and di Donato, 2005).

In this context, family ownership could generate a twofold effect according to the alignment or entrenchment effect prevailing (Wang, 2006).

On the one hand, family firms convey financial information of higher quality compared to the non family ones (Cascino et al., 2010) thanks to the ability of controlling owner to directly monitor the managers (Ali A., Chen T.Y. and Radhakrishnan S., 2007; Anderson & Reeb, 2003b; Demsetz & Lehn, 1985; Shleifer & Vishny 1997; Anderson and Reeb, 2003a). This is consistent with the alignment effect of family ownership producing better EQ (Wang, 2006).

On the other hand, family owners being managers and directors tend to dominate and manipulate earnings (Anderson & Reeb, 2003a; Gilson & Gordon, 2003; Anderson & Reeb, 2004; Fama and Jensen 1983; Morck et al. 1988). This is consistent with the entrenchment effect of family ownership producing worse EQ (Wang, 2006).

### **Earnings quality and its different measures**

In recent years the quality of financial reporting has become an increasingly interesting topic for the financial world. The academic literature embraces several definitions of EQ. Some of them focus on the

persistence of earnings meaning that current earnings can be considered a good indicator of future earnings (Hodge, 2003; Chan et al., 2006); others consider the relation between accruals and cash flows (Mikhail et al., 2003). One of the main issues is the definition of "high quality" earnings. Kirschenheiter and Melumad (2004) state that high quality earnings are more informative and closer to the long-run value of the firm. In Continental-European countries the practice of conservative accounting is claimed as producing higher quality earnings, consistently with the definition of White et al. (2003). A possible explanation for the multiplicity of those different interpretations could be that different readers use information to make different decisions (Kirschenheiter and Melumad, 2004).

The main difficulty to treat EQ is the lack of a generally accepted measurement approach. Various measures have been proposed (Bernstein, 1993; Balsam et al., 2003; Dechow et al., 2004; Francis et al., 2006; Schipper and Vincent, 2003). In particular, Francis et al. (2004), identify seven measures of earnings quality widely used in accounting research. They characterize the seven earnings attributes as either "accounting-based" or "market-based" depending on the underlying assumptions about the function of financial reporting<sup>1</sup>.

The accounting-based approaches use abnormal accruals as measures of EQ. The accruals models distinguish between normal or non-discretionary accruals (related to the firms' fundamental earnings process) and discretionary or abnormal accruals, assumed to be the result of intentional or unintentional accounting errors. Higher levels of abnormal accruals, not associated with companies' fundamental earnings process, are assumed to reduce the quality of earnings and, for this reason, are an inverse measure of EQ. Dechow and Dichev (2002) consider the importance of the matching function of accruals to cash flows and thus model accruals as a function of current, past, and future cash flows because accruals anticipate future cash collections/payments and reverse when cash previously recognized in accruals is received/paid<sup>2</sup>.

<sup>1</sup> The accounting-based earnings attributes consider cash or earnings (or other measures that can be derived from these, such as accruals) that are estimated using accounting data assuming that the function of earnings is to allocate cash flows to reporting periods via accruals. The market-based attributes take returns or prices as the reference construct and rely on both accounting data and returns data for their estimation assuming that the function of earnings is to reflect economic income as represented by stock returns (Francis et al, 2004).

<sup>2</sup> If "normal" accruals are the predicted value from a regression model of accruals associated with the firms' fundamental earnings process, then abnormal accruals represent estimation errors, which can be intentional or unintentional.

## Research questions and hypotheses development

As the existing literature shows, the relationship between family ownership and EQ depends on the prevalence of entrenchment or alignment effect (Wang, 2006). We argue that the effect depends mainly on family involvement in the board and on the existence of checks and balances between decisional and control powers. So, the effects of family ownership on EQ are studied through family involvement in the governance bodies ("familiness").

We hypothesize that a higher family involvement in the board (i.e. board participation) leads to higher EQ but only if the CEO is not a family member. This is consistent with the evidence of nonlinear effects of familiness on performance (Sciascia and Mazzola, 2008).

The rationale is that the higher the family involvement in governance, the stronger the management monitoring activity by the family, with the alignment effect prevailing (Wang, 2006), unless the family becomes dominant and uses its power for its own interest, lowering the effectiveness of controls.

On the other hand, the lower the family involvement, the stronger the CEO excessive power if he is not a family member, with the entrenchment effect prevailing (Wang, 2006).

We expect that if the family is highly involved in the governance of the company, it will be more willing to protect its reputation through a transparent reporting (James, 1999; Kwak, 2003; Stein, 1989; Weber et al., 2003) and an effective monitoring role of family board members (Mustakallio, Autio and Zahra, 2002; Tagiuri and Davis, 1996), while, in contrast, a lower family involvement leads to higher information asymmetries between the board and the CEO (if he is not a family member) and higher incentives to earnings management<sup>3</sup>.

But we expect the relationship to be different according to the familiness of the CEO. In case of a high family involvement coupled with an external CEO, we expect a higher EQ because of the effective monitoring and alignment attributable to family directors, balancing the power of the CEO and his earnings manipulation incentives.

We expect the same results in case of a family CEO but coupled with a low family involvement in the board. Also in this case the alignment effect prevails, thanks to direct ownership interests in the company (Mengoli, Pazzaglia and Sapienza, 2011). In this situation, CEO incentives to extract private

benefits are mitigated by check and balance mechanisms.

Instead, in case of a family CEO along with many family members in the board, the entrenchment effect prevails because the family become dominant and checks and balances are ineffective. Non executive family directors are faithfully aligned to the decisions of the family CEO, implying that a higher family involvement in the board could increase the entrenchment of the family CEO, strengthening his excessive power (Burkart et al., 2003).

According to the general hypothesis of a positive effect of "checks and balances" on EQ, we formulate the following hypotheses.

*Hypothesis 1: A higher family involvement in the board leads to higher earnings quality, but only when the CEO is not a member of the family.*

The explanation of the above hypothesis is that higher board familiness increases the monitoring role of the family, but in case of a family CEO, the higher family involvement in the board increases the entrenchment of the family CEO, strengthening his excessive power. In this situation, in fact, check and balance mechanisms get to be ineffective.

*Hypothesis 2: The presence of family CEOs leads to higher earnings quality, but only when it is not associated with high family involvement in the board.*

The explanation of the above hypothesis is that the presence of a family CEO makes the alignment effect stronger thanks to his direct involvement in the ownership, but a dominant presence of family directors increases the entrenchment of the family CEO, strengthening his excessive power. In this situation, check and balance mechanisms get to be ineffective as well.

## Family Firms in Italy

To test our hypotheses, we use a sample of Italian-listed companies. Italy is particularly suited for our purpose thanks to the high number of listed family firms where controlling families have a strong leadership (Corbetta and Minichilli, 2005; Bianco and Casavolta, 1999; Bianchi et al., 2001; Volpin, 2003; Brunello, Graziano and Parigi, 2003) and are usually involved in the activities of the firm through the appointment of family members to the board of directors or in CEO positions (Prencipe, Markarian, and Pozza, 2008).

In Italy there are very few publicly held companies, most companies are closely held and entrepreneurial families play a decisive role in the economic system performance. Moreover, in the last ten years, State controlling ownership has been reduced by privatizations with the spreading of a "coalition model" of companies' control, mainly based on shareholders agreements often involving families (A 2003 survey of listed non-financial Italian companies reports that 67% of these firms are

<sup>3</sup> In fact, family non-executive directors are much more active than other external non-executive or independent directors, thus causing the effect of family members involvement to be stronger than the effects of external independent directors (Davis, Schoorman, and Donaldson, 1997).

classified as family-controlled companies (Corbetta and Minichilli, 2005)).

Family ownership has also an effect on corporate governance systems because shareholders appoint both the board of directors and the controlling body.

In the last few years important reforms have strongly changed the features of corporate and financial markets law, which is nowadays characterized, at least formally, by a high degree of investor protection. Listed companies have also adopted a self-regulation code aligned with international best practices. Nevertheless, these reforms have not led to shareholding fragmentation nor to a decrease in family control. Thus, Italy is an important example of a country in which family capitalism is persistent even after important reforms in both corporate and financial regulation. So, Italian market represents a good setting to test the effects of *family governance* on financial reporting quality.

## Methodology

### The sample

The sample includes Italian companies listed on the Milan Stock Exchange Market (MSE) over the period 2002-2004. Banks, insurance companies, other

financial intermediaries and public utilities were excluded from the study for different reasons. Firstly, family firms in these industries are quite absent and business activities are barely comparable with the ones where family firms are involved. Moreover, financial companies, in the observed period, had a different accounting regulation from other companies. Finally, public utilities have a special regulatory environment which is likely to influence incentives of earnings manipulation.

The sample was selected over the period preceding the adoption of the International Accounting Standards (IFRS), in order to avoid complexities related to the transition and implications of its adoption for EQ (Nevertheless we tested our hypotheses also considering two more years after IFRS adoption and the results were confirmed).

The Italian stock market is relatively small. The total number of companies listed on the MSE is 261, 262 and 263 in 2002, 2003 and 2004 respectively. Financial reporting data are taken from Datastream database. Due to some missing data and the selection criteria illustrated above, in order to provide homogeneity, the sample is restricted to 126 companies for every year (378 firm-year observations overall). Table 1 provides a description of the sample.

**Table 1.** Sample Composition

	YEAR 2002	YEAR 2003	YEAR 2004
Listed Companies on MSE	231	227	232
Financial companies and utilities	-92	-91	-99
Missing data (financial and/or governance)	-13	-10	-7
<b>TOTAL SAMPLE</b>	<b>126</b>	<b>126</b>	<b>126</b>

### Methodology of the analysis

We use the residuals of the original Dechow-Dichev model as a measure for earnings quality (Dechow-Dichev, 2002)<sup>4</sup>. Earnings manipulation, and thus EQ, is strictly related to the management of discretionary items of financial statement, such as working capital, depreciation, R&D expenses. In the Italian context working capital items are the ones that better explain EQ as depreciation policies usually follow taxation rates and R&D activities are not so relevant for family firms. The working capital accruals are then the easiest items to be discretionarily manipulated, making the Dechow-Dichev model optimally fit the setting of the analysis.

Firstly, we confirmed the validity of the assumptions of the Dechow-Dichev (2002) EQ measurement model for our sample. Then, we

calculated the EQ measure as the residuals from the regression of changes in working capital on past, present and future operating cash flows<sup>5</sup>. Finally, we performed two linear regression models in order to analyze the relation between the EQ measure and the independent and control variables.

### The dependent variable: EQ measures from Dechow-Dichev

According to Dechow-Dichev (2002) method, we derived a practical measure of working capital accrual quality using the following firm-level time-series regression:

$$\Delta WC_t = \alpha_1 + \alpha_2 CFO_{t-1} + \alpha_3 CFO_t + \alpha_4 CFO_{t+1} + \varepsilon_t$$

<sup>4</sup> Due to the small number of listed companies on Milan Stock Exchange, the use of alternative measures of EQ requiring time-series data and a very high number of companies related to the same industry classification could not be used.

<sup>5</sup> According to the model, these residuals are a proxy of the "abnormal accruals" that are discretionary adjustments expressing dis-alignment between earnings and cash flows from the operations of a given year, which do not reverse in the previous or in the following years.

where:

$DWC_t$  = change in Working Capital time t

$CFO_{t-1}$  = Cash Flow from Operation time t-1

$CFO_t$  = Cash Flow from Operation time t

$CFO_{t+1}$  = Cash Flow from Operation time t+1

The relevance of the model is confirmed by the data of our sample ( $R^2$  is high for every year of the analyzed period and in the pooled regression (378 firm-year observations) the adjusted  $R^2$  is 0,53. The residuals of the regression analysis, expressing

$$EQ_t = b_1 + b_2(\%FAMDIR)_t + b_3(\%INDIR)_t + b_4(ID/CO)_t + b_5(CEODUAL)_t + b_6(LOGASSET)_t + b_7(ROA)_t + b_8(LEV)_t + b_9(LOSS)_t + b_{10}(GROWTH)_t + e_t \quad (1)$$

$$EQ_t = b_1 + b_2(\%FAMDIR)_t + b_3(\%INDIR)_t + b_4(ID/CO)_t + b_5(CEODUAL)_t + b_6(LOGASSET)_t + b_7(ROA)_t + b_8(LEV)_t + b_9(LOSS)_t + b_{10}(GROWTH)_t + b_{11}(CEOFAM)_t + b_{12}(CEOFAM * \%FAMDIR)_t + e_t \quad (2)$$

where the subscript t represents the time and the other variables are defined as follows.

EQ is the absolute value of residuals expressing abnormal accruals according to Dechow-Dichev model. %FAMDIR is the proportion of family members in the BoD, measured as the ratio between family directors and the total number of board members. It is expected to mitigate the “entrenchment effect” and contribute at higher earnings quality. %INDIR, representing board independence, is measured as the number of independent directors out of total members of the board. It is expected to mitigate the “entrenchment effect” and contribute to higher earnings quality.

The name and the number of directors are disclosed by companies in their annual governance reports. The identification of family members is based on the surname and other information about independence and family relations included in the public reports, or in other public sources. The identification of independent directors is based on the compliance with the definition provided by the Self-regulation Code, as stated by the company.

ID/CO represents Bank/Firm connections. It exists if at least one director is in common between a firm and a listed bank (interlocking directorate) or if there is a cross-ownership between banks and the firm for at least 2% shareholding (cross-ownership)<sup>6</sup>. This is a dummy variable equal to 1 if at least one of the two conditions exists, 0 otherwise. Bank/Firm connections are expected to create incentives for better reporting quality.

CEODUAL represents CEO Duality. It is expressed by a dummy variable equal to 1 if CEO is different from the chairman of the board and 0 otherwise. CEO Duality is a signal of top

abnormal accruals, are then used as an EQ measure on a firm-year observation basis: the higher are the residuals the lower is the EQ).

### The independent and control variables

We measured family involvement as the proportion of family members in the BoD (FAMDIR, also referred as “board familiness”). In order to test our hypotheses, we run the following regression models:

management entrenchment expected to have a negative correlation with EQ.

Following prior literature (Becker et al., 1998; Raffournier, 1995; Reynolds and Francis, 2000; Ho and Wong, 2001; Wang, 2006), the models control for: Size, expressed by LOGASSET (logarithm of Total Assets), profitability, expressed by ROA (ROA), risk of bankruptcy, expressed by LEV (Debt/Equity ratio), LOSS (dummy variable equal to 1 if net income is negative and 0 otherwise), and growth opportunities, expressed by the growth rate in sales (GROWTH).

Moreover, in the second regression model we tested the effects of family involvement on EQ depending on the CEO being a family member or not, through the following independent variables:

- CEOFAM expressing the presence of a Family CEO, a dummy variable equal to 1 if CEO is a family member, 0 otherwise.
- %FAMDIR\*CEOFAM expressing the interaction between the proportion of family directors and family CEO, in order to test the effects of their simultaneous presence.

### Sample descriptive statistics

Before considering the results of our analysis, we briefly resumed descriptive statistics about the sample, divided into two sub-samples of family and non family firms. For the purpose of this descriptive analysis, a company is defined “family firm” if two conditions are respected: 1) there is a single or a few controlling families owning at least the 20% of voting rights<sup>7</sup>; 2) at least one member of that families (also relative in law), has a seat in the board of directors.

<sup>6</sup> This percentage is the threshold required by CONSOB in order to publicly declare relevant shareholding interests.

<sup>7</sup> The voting rights can be owned directly, indirectly or through voting agreements and voting trust (as a device for co-ordination between significant shareholders)

The information presented below refers to the period 2002-2004.

Family companies are around 56% of the total sample. We calculated means, standard deviations and independent samples t-tests.

Here the results:

**Table 2.** Descriptive statistics and t test

	Mean values		SD		t	Sig
	Family	Non Family	Family	Non Family		
Observations	213	165				
CEO Fam	0.65		0.48		-11.37	0.00
CEO Duality	0.43	0.36	0.50	0.48	-1.25	0.21
FAMDIR	2.28	0.18	1.33	0.60	-18.87	0.00
Net Debt/Equity	0.98	1.31	3.18	6.50	0.65	0.51
ID/CO	0.60	0.58	0.49	0.50	-0.49	0.62
ROA	0.79	0.16	29.96	27.62	-0.20	0.84
INDIR	3.03	4.14	1.71	3.16	4.35	0.00
LNTOTASSETS	13.05	13.26	1.27	1.78	1.26	0.21
GROWTH SALES	16.03	3.74	72.70	30.00	-1.96	0.05

Non family firms show, on average, a higher level of indebtedness (1.31) compared to family firms (0.98), but the mean difference is not significant. Family firms also present higher ROA, although the significance level is not high. Moreover, on average, family and non family firms have more or less the same size and the formers are more characterized by CEO duality (even if mean values are not significant). This is consistent with the opinion that family control is a constraint to growth and entails higher risk of “entrenchment” of top management. The average percentage of independent directors is 37% in family firms and 63% in non family ones. Both family and non family firms have more or less the same frequency of connections with banks (0.60 / 0.58), a

typical feature of Italian capitalism confirming the pervasive power still held by banks in Italy. Finally, the average number of family CEOs in family firms is around 0.65, meaning that many family firms have a family CEO.

### Empirical Results

The regressions analyses have been performed through a panel model, on 378 firm-year observations. Table 3 and Table 4 present, respectively, the results for the first and the second regression. The “model fit” for both is quite good (*adjusted R*<sup>2</sup> 0.338 and 0.333 respectively).

**Table 3.** First regression results (1)

Independent variables	Beta coefficients	t	Sig
COST 2002	-1073736	-9.490	0.000***
COST 2003	-1115322	-10.020	0.000***
COST 2004	-1109768	-9.976	0.000***
CEODUAL	54092.174	2.259	0.024*
%FAMDIR	-149419.681	-2.272	0.023*
LEV	-6575.141	-0.955	0.340
ID/CO	-53192.225	-2.182	0.029*
ROA	-92.692	-0.187	0.851
%INDIR	54143.678	1.049	0.295
LOSS	84454.673	2.945	0.003**
GROWTH	4168.321	0.336	0.820
LOGASSET	203436.517	10.719	0.000***
<i>Adj. R square</i>	0.338		
<i>F-statistic</i>	15.897		

Table 4. Secondo regression results (2)

Independent variables	Beta coefficients	t	Sig
COST 2002	-1079816	-9.226	0.000***
COST 2003	-1122892	-9.707	0.000***
COST 2004	-1115806	-9.686	0.000***
CEODUAL	55096	2.278	0.023*
%FAMDIR	-260890	-1.893	0.059
LEV	-14982	-1.330	0.184
ID/CO	-49803	20.230.706	0.044*
ROA	-6.173	-0.012	0.990
%INDIR	41697.00	0.7951	0.427
GROWTH	7068.00	0.374	0.708
LOSS	86043	2.882	0.004**
CEO Fam	-95380	-2.260	0.024*
%FAMDIR*CEO FAM	312480	1.796	0.073*
LOGASSET	209120	10.644	0.000***
Adj. R square	0.333		
F-statistic	13.606		

In both models, the regression coefficient of board familiness (%FAMDIR) is negative and significant ( $t$  equal to - 2.272 and - 1.893 respectively). Moreover, in the second regression model, the regression coefficient of family CEO (CEO FAM) is negative and significant ( $t = -2.260$ ). The coefficient of the interaction variable %FAMDIR\*CEO FAM is positive and significant ( $t = 1.796$ ).

The results of the regression models confirm both *H1* and *H2*.

As the dependent variable is an opposite measure of EQ, the results of both regressions confirm that a stronger presence of family members in the board has a positive effect on EQ. Moreover, the presence of a family CEO has also positive effects on EQ confirming the alignment effect relevance (Wang, 2006).

But the positive effects of family directors and family CEOs are not confirmed when they are combined. The interaction variable between family CEO and the percentage of family directors (%FAMDIR\*CEO FAM) shows that the positive effect of family involvement on EQ is no longer confirmed when they are simultaneously present. In our perspective, it happens because the board is more likely to be dominated by the key members of the family.

It is interesting to notice the result regarding independent directors. In both models there isn't significant correlation between EQ and independent directors in the board. The lack of correlation between these two variables is inconsistent with the dominant theory (a stronger presence of independent directors should positively affect firms' disclosures), but confirms doubts about the effectiveness of independent directors in the Italian context.

In order to test the robustness of our model, we performed a further regression analysis using the ratio Residuals/Revenues as dependent variable, instead of the absolute value of Residuals, for a better control of

the size effect. On the whole, the results confirm our hypotheses.

## Conclusions

The article contributes to existing literature about the analysis on the relationship between firm familiness and EQ, mainly focusing on the family attitude towards corporate governance practices. A general result is the existence of a positive correlation between family involvement in the governance of the company and EQ, but only when this doesn't imply an excessive power of the family. So, what really counts for earnings quality is not the "familiness" *per se*, but the distribution of powers and controls set by the governance system.

Hence, family governance is good for earnings quality, but not when the family gets to be dominant in the board (when, at the same time, many family directors and a family CEO join the board).

This result, as far as we know, is partially novel. These findings show the potential efficiency of the "family model" in reducing agency costs and gaining trust through transparency, thus creating an essential precondition for cost of capital reduction, but they also suggest as the "family model" is really efficient only in case of good governance practices, in order to moderate the entrenchment effects of family ownership and management. The findings have implications for entrepreneurs, regulators and financial reporting users, suggesting that, on the one side, family firms not adopting good governance practices deserve more attention by financial and accounting regulators and that, on the other side, the adoption of good governance practices increases the transparency and efficiency of the relation between entrepreneurs and investors.



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