

Corporate Governance issues in Family and Non-Family Owned Firms: an Empirical Analysis of CEO Compensation, Executive Turnover, and Earnings Management.

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Abstract

Why is corporate governance relevant? What is corporate governance for? There are numerous interesting questions regarding corporate governance and its relevance in the academic and corporate world. As widely known, managers' interests and objectives differ from those of the shareholders. The formers aim at maximizing their remuneration and personal wealth. They often engage in selfish behaviors, using shareholders' money in beyond-the-core activities in order to build an empire of large, diversified, and global business, which often underperform more focused companies (Lev, 2012).

In this regard, corporate governance aims at minimizing these conflicts of interests (i.e. agency costs), even though whether or not it mitigates such agency conflicts is still an unanswered question. Specifically, corporate governance is made by a large number of mechanisms, some of which are a result of competitive forces and market conditions (i.e. the market for corporate control, executive compensation, etc.), while others (the majority) are legally imposed (see, e.g., the Sarbanes-Oxley Act in the U.S., and the Codice Preda in Italy). Such mechanisms should monitor managers and punish opportunistic behaviors, thereby aligning their interests with those of the owners.

Most of the academic research on corporate governance has been largely focused on widely held public corporations. In this class of firms the ownership is dispersed amongst a multitude of investors. As a consequence, agency conflicts arise between managers and shareholders given the separation between ownership and control (Jensen and Meckling, 1976). This ownership structure is typical in countries with high legal investor protection (Zingales, 1994; Volpin, 2002), such as the United States and the United Kingdom.

Despite much of the research focusing on widely held public firms, in fact, family firms represent the dominant ownership form in the corporate world (Faccio and Lang, 2002). Even though it may sound unconventional, in the United States (which is broadly recognized as a country of dispersed ownership) more than 40% of the public corporations in the S&P500 can be classified as family firms (Chen et al. 2013).

As a consequence, in the last three decades, research on family firms has grown in importance among scholars, with prominent studies appearing at the end of the past century. In the Italian academic history, early works regarding family firms are Tomaselli (1996), and Corbetta (1998). In the past decade, family business studies have become important also at international level. For instance, some studies have firstly documented the diffusion of family ownership worldwide (Faccio and Lang, 2002), while others, although failing to obtain unambiguous empirical evidence, have found evidence for a higher financial performance of family controlled firms as compared to non-family firms (see, e.g., Anderson and Reeb, 2003; McConaughy, et al., 2001; Sraer and Thesmar, 2010).

The definition of what constitute a family firm is somewhat ambiguous in the literature. Family firms could be small businesses held by a family, but also large multinational firms. My work defines family firms, consistent with previous studies (see, e.g., Volpin, 2002; Tiscini, 2008; Faccio and Lang, 2002; Anderson and Reeb, 2003; Villalonga and Amit, 2006; Brunello et al., 2001, 2003), as publicly traded companies, which are directly

controlled by one or more families, or by an individual who has publicly disclosed his intention to pass the baton to one of his relatives.

Research on family-owned companies typically focuses on the conflict between majority shareholders (the controlling family) and minority shareholders, also known as Type II agency problem (Villalonga and Amit, 2006). These studies show that typical agency conflicts of interests between shareholders and managers (Type I) are mitigated by family ownership. In fact, different from widely held non-family firms, the ownership structure of family-owned companies allows the controlling family to monitor more easily the CEO (who, often, is a member of the controlling family). Furthermore, the family holds significant power, given the concentrated ownership, that may occasionally lead to collusion between managers and the controlling family (Brunello et al., 2001). The Chief Executive Officer (i.e., the CEO) may collude with the dominant family, extracting rents from minority shareholders, even in cases where he/she is an externally hired professional manager (Zingales, 1994; Volpin, 2002). Minority shareholders usually provide a great percentage of the firm's capital, but are often deprived of a real influence on the management of the firm. Frequently family-owned firms engage in transaction with other family-related businesses, subtracting corporate funds from minority shareholders. In such situations, effective corporate governance protecting minority shareholders is needed. Moreover, recent studies (e.g., Gomez-Mejia et al., 2007; Tiscini, 2008; Berrone et al., 2012) have outlined that family firms present some peculiarities with respect to the family's (or the CEO in cases where he is a family member) aim at non-financial benefits (i.e. Socioemotional benefits, or/and idiosyncratic benefits of control).

This dynamic opens the field to research regarding corporate governance in family-owned firms, because these family firm's characteristics logically lead to impact the corporate governance of the firm. As a consequence, some traditionally studied mechanisms of

corporate governance may work differently in family-owned firms when compared to non-family firms.

The literature on executive compensation, for instance, is mainly tied to widely held public companies and to the Type I agency problems (conflicts of interests between managers and owners). Many authors¹ have examined the importance of managerial incentives in achieving benefits for the shareholders and, as a consequence, improving the firm's performance. Their findings point to the existence of executive compensation contracts, based on incentives for performance, reducing the costs associated with the Type I agency problems between managers and shareholders. Hence, these results point to the necessity to align the interests of managers and shareholders in order to incentivize managers to create value for the owners. On the other hand, in family owned companies the ownership concentration and the easier monitoring (by the family on the board of directors) should lead to a reduction of the agency problems between managers and shareholders (Villalonga and Amit, 2006). Moreover, for cases in which the CEO is a member of the controlling family the interests of owners should coincide with the ones of managers. As a consequence, we should expect that the typical mechanism of aligning interests of managers and shareholders (i.e. the sensitivity of CEO pay to performance) might work differently in family-owned firms when compared to non-family firms.

Another relevant corporate governance mechanism is CEO turnover. The likelihood of CEO dismissal in light of poor firm performance is often considered indicative of whether a firm is well governed; in fact, well-governed firms are more likely to dismiss their CEOs for poor performance than are poorly governed firms (Kaplan, 1994). Accordingly, several studies have empirically documented a negative association between CEO turnover and firm performance in public corporations. This literature is premised on the idea that poor firm

¹ See, e.g., Coughlan and Schmidt's (1985) Murphy (1985), Jensen and Murphy (1990), Mehran (1995), Aggrawal et al. (1999), Core et al. (1999) Bebchuk and Grinstein (2010).

performance leads firm owners to infer that their manager's ability to create shareholder value is lower than a potential replacement's, leading them to replace their CEO. However, the likelihood of a CEO's performance related dismissal is also affected by the diligence with which executive performance is monitored and acted upon by owners, i.e. their firms' governance systems. The ability of owners to replace poorly performing management is, in turn, affected by their effective control over firm governance. The law and finance literature documents that ownership structures that concentrate power in the hands of controlling shareholders, often-family members, limit the ability of other (minority) shareholders to discipline management (La Porta et. al, 1999). In some instances, controlling shareholders further enhance their control of the firm by appointing family members as chief executives (Volpin, 2002). This could create differences in the likelihood of CEO turnover between family and non-family controlled companies.

Finally, another important corporate governance mechanism is the one regarding the punishment of the managers' opportunistic behavior of misrepresenting the firm's financial performance in order to achieve selfish objectives, i.e. the earnings management. The literature on earnings management focuses extensively on the expected costs that earnings management imposes on shareholders. Haley and Wahlen (1999) define earnings management as the alteration of a firm's reported economic performance by insiders to either mislead stakeholders or to influence contractual outcomes. Along this line, much of the past research examines manager's expected private benefits from engaging in earnings management². Many previous studies show that the managerial incentive to misrepresent firm's financial performance through earnings management arises, in part, from the conflict of interest between the firm's managers and shareholders (Type I) and the information asymmetry associated with this separation. Hence, it could be an opportunity to expand on the

² see, e.g., Bergstresser and Philippon 2006; Chung 2002; Frankel, Johnson, and Nelson 2002; Hazarika et al. 2012; Healy and Wahlen 1999; Leuz et al. 2003; Mergenthaler, Rajgopal, and Srinivasan 2012.

issue of corporate governance and earnings management using family firms, in which the traditional Type I agency problem has been shown to be mitigated. As a consequence, the extreme corporate governance mechanism aim at preventing/punishing such opportunistic behavior (i.e. the CEO turnover) might work differently in family-owned firms when compared to non-family firms.

From this standpoint, this dissertation aims at filling a gap in the business literature by investigating some unstudied family firms' corporate governance issues, and providing empirical and theoretical contribution to the field of family business. The analysis is empirical archival, based on a hand-collected sample of non-financial Italian publicly traded companies from 2006 to 2010. In this setting of family and non-family firms, I developed my work studying how family ownership may affect corporate governance mechanisms behind CEO compensation, CEO turnover, and earnings management. As a consequence, this dissertation is divided into three main Chapters.

In Chapter 1, I analyze the CEO compensation in family and non-family firms, and I study the sensitivity of CEO pay to performance. I find CEO pay for performance sensitivity being higher for non-family firms with dispersed ownership than for family firms. The lower agency conflict of family-owned firms, and the easier monitoring on the board of directors explain the results. Furthermore, within family-owned firms, the pay for performance sensitivity of professional CEOs is higher than the pay for performance sensitivity of family CEOs, because family CEOs incentives are tightly aligned with those of the controlling family, and they are also motivated by the preservation of the corporate control. Robustness tests rule out competing hypotheses that family rent extraction purposes, or similar level of ownership concentration (i.e. the blockholder-controlled firms), may drive the results. Finally, this part of my dissertation demonstrates that, in the Italian sample, accounting performance is

more important than stock market returns in setting the CEO pay for both family and non-family firms.

In Chapter 2, I begin by examining the likelihood of performance-related CEO turnover in family firms. I find that the likelihood of performance-related turnover is lower in family controlled firms as compared to firms with dispersed ownership. However, CEO turnover is sensitive to both stock market and accounting performance in non-family firms, but is only sensitive to accounting performance in family-controlled firms. Furthermore, if the CEO is a member of the controlling family, turnover is insensitive to both stock market and accounting performance. I provide evidence that family ties drive the lack of sensitivity of family-CEO turnover to performance rather than concentrated ownership by blockholders. My results are consistent with family ownership exacerbating the conflict between majority and minority shareholders, and family ties creating executive entrenchment.

Finally, I analyze the directional change of performance-related CEO turnover. Results show that family firms with family CEOs are more willing to replace the family CEO with another family member. However, when the firm reports negative accounting performance, the probability that the new CEO is another family member decreases. On the other hand, family firms with professional CEOs are more willing to replace professional CEOs with another professional manager. Notwithstanding, when the firm reports a negative market performance, the probability that the new CEO is a family member increases. I posit that in cases of family CEO dismissals due to poor accounting performance, the family may feel the need of professional assistance. Also, in cases of dismissed professional CEOs, driven by low market performance, a family firm may feel threatened by potential takeovers and may appoint a family member to prevent any corporate raiders.

In Chapter 3, I investigate the moderating effect of family ownership on the relation between earnings management and CEO turnover. Consistent with agency theory, I find a

positive and significant relation between earnings management and CEO turnover in the overall sample, the association being primarily driven by non-family-owned firms. In family-owned firms, I find that the positive relation is reduced. Furthermore, I find the association to be insignificant in cases where the CEO is a member of the controlling family. Robustness tests rule out competing hypotheses that differences in the propensity of family and non-family firms to manage earnings and ownership concentration drive my results. The study contributes to our understanding of family ownership driven differences in corporate governance systems, a relatively unexamined topic in the literature.

This dissertation aims to shed new light in the field of corporate governance of family-owned firms. In particular, I aim to demonstrate that family firms' characteristics (such as the collusion between the controlling family and managers, the benefit of control, and the socioemotional wealth) affect some corporate governance mechanisms, moderating the results found in widely held non-family firms. Finally, I study conflicts of interests between majority and minority shareholders (Type II agency problems), which can lead to collusion between the dominant family and managers, and the family's extraction of private benefits. In this regard, I show when and how corporate governance's mechanisms act to prevent and/or punish managers' opportunistic behavior.

Every chapter of this dissertation provides several contributions to the literature of corporate governance of family-owned firms. Firstly, Chapter 1 speaks to the agency theory, giving empirical evidence that the incentive alignment role of compensation plans, as predicted by optimal contracting theory, is mitigated when the interests of managers and the main shareholder (i.e. the dominant family) are aligned, or when monitoring is high as is the case of family-owned firms. In fact, in Chapter 1 I demonstrate that CEO pay for performance sensitivity is lower in family than in non-family firms. The findings are motivated by the lower agency problems and easier monitoring of family-owned firms. Family-controlled firms

show less need to align the interest of CEO and shareholders, because monitoring by the dominant family is higher than the monitoring by shareholders in non-family firms with dispersed ownership. Moreover, when a family member acts as CEO, his interests are aligned with those of the dominant family by family ties. Indeed, I find that family CEOs are the ones with the lowest pay for performance sensitivity. Notwithstanding, family firms with family CEOs perform better as compared to non-family firms, thus confirming that CEO compensation is not an instrument of family's benefit (rent) extraction. This insight is completely new and crucial in explaining how the family's preservation of the benefits of control affects governance mechanisms.

Secondly, Chapter 2 builds on previous studies that have documented a negative relation between CEO turnover and firm performance, predicting that when firm performance decreases, CEOs are replaced because they were not able to increase firm's value. In this part of the dissertation, I empirically demonstrate how family ownership and familial relations directly affect the turnover-performance sensitivity. Of interest to this particular study is how the CEO turnover process works in family controlled companies, which performance measure counts more and what are the underlying differences between family and non-family firms (both widely held non-family firms and blockholder-dominated companies). In this regard, in Chapter 2 I make several contributions to the literature of turnover-performance relation. First, I outline the importance and the impact of family control on the CEO turnover-performance sensitivity. I shed lights on the relative importance of the different performance measures used in evaluating a CEO in family and non-family firms. I find that non-family firms put more weight on stock market returns than accounting performance, while family firms just rely on the accounting performance. I interpret these findings as proof that better monitoring by family firms matter when evaluating a CEO. Non-family firms (especially the one with dispersed ownership) do not have such monitoring power, thus their shareholders

have to consider more the market return, that in this case appears more accurate than accounting performance, in evaluating CEOs (when the monitoring is low the accounting measures of performance is a weaker performance signal). On the other hand, family firms rely on the accounting performance because it is more accurate in evaluating poor performing CEO. In fact, the family is more focused on the accounting performance, being the source of its main gain (i.e. the dividends). Moreover, I show that, in the family firms' sample, the professional CEOs are the ones that drive the results, because family related CEOs are not replaced for poor performance. This finding underlines the high benefits of control that lead to entrenchment. Furthermore, it is critical for the understanding of the corporate governance mechanisms of family firms and, also, it could be a clue for future research that aims to study the market reaction to such behavior. Additionally, the tests for blockholder-dominated firms show how they put weight on both measures of performance providing support for my view of the importance of monitoring in determining the relative weights put on the measures of performance. It also serves to show once again that the differences between family and non-family firms are not due to the ownership concentration, but rather are due to the family firms' characteristics and familial relations. Finally, I show that family firms decide to replace a family CEO with a professional manager just when they need professional assistance (i.e. in cases of bad accounting performance). Instead, family firms replace a professional CEO with a family member in cases of low stock market returns, hence when the family feels threatened by potential takeovers and decide to appoint a family member in order to prevent any corporate raiders.

Thirdly, Chapter 3 builds on what demonstrated in Chapter 2, and examines the understudied topic of CEO turnover and earnings management in family-controlled firms. Given the prominent role of the agency problem (i.e. managers extracting private rents at a cost to shareholders) in driving earnings management the firm's corporate governance system

must be structured to minimize the incentives of managers to engage in earnings management. As a result, I focus on one of the most extreme mechanisms boards have to discipline managers: CEO dismissal. In this regard, I provide evidence as to two distinct corporate governance systems: the one found in widely held firms, where the opportunistic behavior of extreme earnings management is punished with the CEO dismissal, and the one found in family-controlled firms, where the behavior is not punished. This chapter provides further evidence as to the differences in corporate governance mechanism and the care with which current results grounded in widely held firms should be applied to cases of family firms. Furthermore, it shows that in family-owned firms, the corporate governance's mechanism aim at preventing opportunistic behavior such as extreme earnings management does not work, underlining collusion between managers and the dominant family.

In conclusion, this dissertation shows that the corporate governance of family-owned firms significantly differs from that of non-family firms. Family firms' characteristics, such as the collusion between the family and managers, the socioemotional wealth, and the idiosyncratic benefits of control, moderate results found in the previous studies for widely held (non-family) public corporations. Although family-owned firms report higher financial performance for the years here analyzed as compared to non-family firms, they present weaker corporate governance, hiding entrenchment and collusion between the dominant family and the management of the firm.

The need for stronger corporate governance in family-owned firms is clear, and the findings of this dissertation are in line with what also claimed in some previous studies: "Family firms need to empower minority shareholders by effecting financial disclosure and auditing, along with strict internal rules to prevent self-dealing and transactions with family-related businesses" (Lev, 2012).