Earnings Management around CEO Successions in Family Firms

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ABSTRACT

This paper explores whether family firms that are intend on replacing the incumbent family CEO by another family member are more likely to engage in earnings management than family firms that appoint a non-family CEO. The sample includes CEO successions in listed family firms in France, Germany and the UK over 2001-2010 and whose incumbent CEO is a member of the controlling family. We argue that in order to safeguard their private benefits of control, family shareholders aiming to replace the incumbent family CEO by another family member use earnings management to boost performance and/or mask bad performance in the year preceding the year of the succession.

When the focus is on accruals-based earnings management (Jones, 1991) we find that the incumbent CEO engages in upward earnings management before the succession whereas the family successor CEO engages in downward earnings management during the first years after the succession. However, we do not find any such consistent effect when we focus on real earnings management. These findings suggest that incumbent family CEOs inflate firm performance to reduce resistance from minority shareholders against the appointment of another family member. In turn, the succeeding family CEO then has to reverse the upward earnings management. There is also evidence that loss-making firms are more likely to engage in downward earnings management whereas growth firms manipulate their earnings upwards. Family wedge, measured as the difference between family control and ownership, board structure and shareholder protection do not have an impact on the earnings management in family firms.

Keywords: Earnings management, family firms, CEO succession, corporate governance, corporate control and ownership.