The current issue and full text archive of this journal is available on Emerald Insight at:
https://www.emerald.com/insight/1743-9132.htm

Sources of incentive and entrenchment effects in family firms: balancing self-dealings with operating efficiencies

Kinshuk Saurabh
Finance and Accounting Area, Institute of Management, Nirma University, Ahmedabad, India

Received 8 June 2022
Revised 6 November 2022
10 April 2023
Accepted 13 April 2023

Abstract

Purpose – The purpose of the study is to examine how operating efficiencies from incentive alignment compensate for rent extraction in family firms. The author asks whether ownership (1) improves operating efficiencies to increase firm value, (2) positively affects related-party transactions (RPTs), or (3) destroys firm value. Finally, the author assesses whether the incentive effect dominates the entrenchment effect.

Design/methodology/approach – This study employs a panel of 333 listed family firms (and 185 nonfamily firms) and handles endogeneity using a dynamic panel system GMM and panel VAR.

Findings – Ownership decreases discretionary expenses and increases asset utilization to add firm value. The efficiency gains generate more value in family firms, especially majority-held ones, than in nonmajority ones. However, ownership is also related to increased RPTs (especially dubious loans/guarantees), reducing firm value. RPTs destroy value more severely in the family (or group) firms than in nonfamily (nongroup) firms. It could be why ownership's positive impact on value is lower in family firms than in nonfamily firms. Overall, the incentive effect dominates the entrenchment effect and is robust to controlling private benefits of control in the dynamic ownership-value model.

Research limitations/implications – (1) A family firm's ownership may not be optimal. (2) The firm's long-term commitment as a dynasty limits the scale of expropriation yet sustains impetus for long-term value creation. The paradox partly explains why large family holdings and firm-specific investments endure over generations. (3) This way, large ownership substitutes weak investor protection in India despite tunneling as skin in the game provides necessary investor confidence. (4) Future studies can examine whether extraction varies with family generations and how family characteristics affect the incentive effects.

Practical implications – (1) Concentrated ownership may not be a wrong policy choice in emerging markets to draw firm-specific investments. (2) Investors, auditors, or creditors must pay closer attention to loans/guarantees. (3) More vigorous enforcement, auditor scrutiny, and board oversight are needed.

Social implications – Family firms are not necessarily a bad organization type that destroys investor wealth. They can be valuably efficient due to their ownership and wealth concentration, and frugality. They matter in the economic growth of a developing market like India.

Originality/value – (1) Extends ownership-performance research to family firms and shows that although ownership facilitates tunneling, the incentive effect dominates; (2) family ownership is not impacted by firm value; (3) family ownership levels reduce discretionary expenses and increase asset utilization to create added value, especially in majority-held family firms; (4) RPTs and loans/guarantees increase with ownership; (5) value erosion from RPTs is higher in family (group) firms than in other firms.

Keywords Ownership structure, Private benefits of control, Related party transactions, Family firms, India

Paper type Research paper

1. Introduction

Sixty-seven percent of India's largest 500 listed and nongovernment-owned firms are family-owned, with a majority shareholding in about half [1] (OECD, 2020). Though

JEL Classification — G3, G34, M40

Funding: This research was not supported by any funding.

International Journal of Managerial Finance

1743-9132
DOI 10.1108/IJMF-06-2022-0257