Does Founder Domination Influence Earnings Management Decisions in Family Businesses?

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ABSTRACT

Manuscript type: Research paper
Research aims: This study examines the influence of founder Domination on Real Earnings Management (REM) in Indonesian family firms, with a particular focus on the moderating effect of firm-level hazard on this relationship.
Design/Methodology/Approach: The sample comprises family businesses in Indonesia's manufacturing sector from 2022 to 2024. Moderated Regression Analysis (MRA) tests the hypotheses.
Research findings: The results indicate that founder-led family firms, or those with founders serving as CEOs, exhibit higher Real Earnings Management (REM) levels. High business risk increases REM in family firms. Family firms in Indonesia's manufacturing sector tend to employ Accrual Earnings Management (AEM) and REM as substitutes.
Theoretical contribution/Originality: This study frames the Socio-emotional Wealth (SEW) trade-off within the Indonesian cultural context of paternalistic leadership and concentrated ownership. It provides empirical evidence that the "Founder Domination" is not static but is contingent upon the firm's business risk.

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Practitioner/Policy implications: It is suggested that the regulators and auditors should increase scrutiny of operational activities (REM) during stable periods, as founders may use these as "substitutes" for more detectable accrual-based management. For investors, the results highlight that a founder's commitment to longevity acts as a natural constraint on opportunistic earnings management during financial crises.

Keywords: Earnings Management Trade-off, Founder Domination, Firm Hazard, Family Business
JEL Classification: M40, M41

1. Introduction

Financial reports convey information to managers regarding their company's performance. The preparation of financial reports for interested parties is guided by financial accounting standards (Donleavy, 2018; Fraditya & Purwaningsih, 2023). In preparing financial statements, financial reporting standards allow managers to exercise judgment, drawing on their knowledge of the business to choose reporting methods, estimates, and disclosures appropriate to the company's circumstances. However, it allows the managers to have their own biases in using their professional judgment for their own interests, but when it is done extensively, it will create opportunities for Earnings Management (EM). EM happens when managers choose not to report the company's true economic performance (Healy & Wahlen, 1999; Kesaulya et al., 2023).

In family-controlled firms, financial reporting quality is governed by a complex tension between financial incentives and Socio-emotional Wealth (SEW). While managers generally utilise professional judgment in reporting, the opportunistic use of this judgment leads to Earnings Management (EM), specifically through two primary mechanisms: Accrual Earnings Management (AEM) and Real Earnings Management (REM). In the Indonesian context, where family firms contribute 82% of the GDP (PwC, 2014), the choice between these mechanisms is not merely technical but a strategic trade-off dictated by the unique institutional and cultural landscape.

In Indonesia, family firms exhibit a high degree of paternalism and prioritise preserving "harmonious relationships" as a core component of their socio-emotional wealth (Roida, 2020). Indonesian founders often utilise a "stewardship" approach that prioritises long-term survival and social legitimacy over aggressive short-term financial reporting (Harsono et al., 2025; Harymawan et al., 2023). On the other hand, the transition to subsequent generations often

introduces a "professionalisation tension" as heirs seek to align with global capital market standards. Recent studies suggest that the transition from the founding generation to successors in Indonesia is particularly sensitive. As family firms move toward a more professionalised structure to meet the demands of the Indonesia Stock Exchange (IDX), the inherent SEW-driven constraints on earnings management probably face friction with the next generation's drive for modernisation and market competitiveness (Giovannoni et al., 2011; Jansen et al., 2023). Consequently, the protective effect of founder domination on financial integrity observed in other emerging markets remains a pivotal, yet evolving, safeguard within the Indonesian corporate governance ecosystem.

Based on the SEW theory, there are different views on the strategic choices made in family companies, which are also related to the company's accounting choices, for example, the decision to engage in earnings management (Gomez-Mejia et al., 2011). Particularly, Achleitner et al. (2014) found that family firms tend to trade off REM and AEM. Family owners opt for this choice since they typically maintain a long-term investment horizon and have a substantial portion of their personal wealth invested in the family firm, rendering them highly sensitive to the negative cash flow implications of REM. Furthermore, research results also indicate that REM poses a lower detection risk compared to AEM. The detection risk reduces the likelihood of reputational damage (Sundkvist & Stenheim, 2023; Zang, 2012). Family firms exhibit a heightened sensitivity to reputational risk relative to financial losses, thereby increasing their propensity to engage in REM over AEM (Sundkvist & Stenheim, 2023).

This research further elaborated that there are fundamental differences between companies run by founding family owners and the next generation (Fang et al., 2018). Research reveals that family attachment to a company is most pronounced when ownership and management are retained by members of the founding generation, whereas this attachment tends to diminish as the business is transferred to subsequent generations (Chua et al., 1999; Fang et al., 2018; Gómez-Mejía et al., 2007; Mullins, 2017). Company founders invest their time, energy, and money in the company since its founding, not to mention reinforcing shared values, norms, and beliefs over time (Hoon et al., 2023). Founder-led family businesses are inclined to prioritise the preservation of their SEW owing to a profound personal affinity with the firm (Gómez-Mejía et al., 2007), a phenomenon corroborated by Zhong et al. (2022).

Previous studies have shown that there is a negative effect of founder domination on earnings management. However, there has not been much research that specifically discusses how these variables affect the decision to make earnings management trade-offs. Therefore, this study tests the effect of founder domination on earnings management trade-offs. Departing from the perspective of SEW Theory, it is suspected that when a family company is led by the founding generation, there is a tendency to choose an earnings management mechanism that prioritises capital preservation because one of the main goals of a family company is the survival and prosperity of the company in the long term and the maintenance of transgenerational wealth (Salehi et al., 2019; Sundkvist & Stenheim, 2023). This protective instinct is highest under the founder generation, where personal attachment to the firm is strongest. While studies in other markets, such as China, show founder domination reduces EM (Ferramosca & Allegrini, 2018). Despite these dynamics, empirical evidence on how founder domination specifically dictates the earnings management trade-off remains scarce.

The role of firm hazard or business risk as a boundary condition is often overlooked. In Indonesia's collectivist business culture, a threat to firm survival has the potential to force founders to compromise their SEW priorities in favour of economic survival (Belda-Ruiz et al., 2022). Prior research indicates that family firms, particularly those led by their founders, are inclined to sacrifice socio-emotional wealth in response to financial decline (Gomez-Mejia et al., 2011; Gomez-Mejia et al., 2010). Moreover, Belda-Ruiz et al. (2022) suggest that when a company's survival is threatened, family firms become increasingly driven by economic considerations, leading them to prioritise financial stability over socio-emotional wealth preservation. Specifically, as systematic risk escalates, family firms are more willing to accept losses in SEW (Belda-Ruiz et al., 2022; Gomez-Mejia et al., 2011; Gómez-Mejía et al., 2007). While prior research has examined the dividend policies of family firms moderated by firm risk, this study shifts focus to the moderating impact of firm risk on earnings management trade-off decisions. Grounded in SEW theory, it is posited that family firms will favour earnings management strategies that mitigate systematic risk, thereby preserving socio-emotional wealth.

This study addresses these gaps by investigating how founder domination influences earnings management trade-offs in Indonesian family firms and whether firm hazard moderates this relationship. Furthermore, it confirms that the accounting decisions of Indonesian

family firms are not merely driven by financial incentives but are deeply rooted in the preservation of SEW. In addition, it provides robust empirical evidence that the family's desire to maintain control and legacy significantly influences earnings management practices. In Indonesia's unique institutional landscape which is characterised by concentrated ownership and collectivist values, family firms appear to treat financial reporting as a strategic tool to protect the family's reputation and long-term survival. These findings suggest that for Indonesian family enterprises, the "emotional stakes" of the business often outweigh the pressures of short-term market performance.

The significant contributions and implications of this study cover three dimensions. Theoretically, it refines SEW theory by demonstrating that the "founder effect" is not static but is contingent on the level of "firm hazard", thus providing a more nuanced "mixed gamble" perspective in emerging markets. Practically, for the Indonesian Financial Services Authority (OJK), the findings suggest that a singular focus on curbing accrual-based manipulation is probably counterproductive; if regulators increase the "cost" of AEM without considering the REM alternative, they potentially inadvertently drive family founders toward more opaque real activity distortions that harm long-term firm value and Indonesian market stability. Socially, it highlights the importance of institutional oversight that respects the unique "stewardship" role of Indonesian founders while protecting minority shareholders from the consequences of legacy-driven accounting choices. Ultimately, these insights assist investors in the Indonesia Stock Exchange (IDX) in better evaluating the reporting quality of family-owned firms by considering the interaction between generational domination and financial health.

2. Literature Review and Hypotheses Development

2.1 Family Firms in Indonesia

Family-controlled enterprises are the predominant feature of the Indonesian corporate landscape. They are the backbone of the Indonesian economy, accounting for a significant majority of listed companies on the Indonesia Stock Exchange (IDX), as they contribute approximately 80% of the country's GDP (PwC, 2014). These firms are characterised by a two-tier board system, highly concentrated ownership, and a paternalistic governance structure deeply rooted in Indonesian social values.

Specifically, Indonesian family firms are deeply embedded in a collectivist culture and a bank-based financial system (Claessens

et al., 2000; Roida, 2020). These firms are frequently structured as business groups (*Konglomerat*), where the founding family maintains tight control through pyramidal ownership and cross-holding structures. Additionally, the family maintains a "hands-on" approach through direct involvement in the Board of Directors and Board of Commissioners. In 2022, the Indonesian Stock Exchange remained dominated by family-owned conglomerates, despite significant competition from state-owned enterprises, particularly in terms of market capitalisation. These family-led businesses have spanned multiple generations, with founders mostly from the "Baby Boomer" era, such as Sinarmas Group (Eka Tjipta Widjaja), Salim Group (Liem Sioe Liong), Astra Group (William Soerjadjaja), and Lippo Group (Mochtar Riady) (Santoso, 2024).

2.2 Earnings Management Concept and Its Trade-off

Earnings management practices are commonly associated with a decline in financial reporting quality, as the information in financial statements does not accurately reflect the underlying economic conditions of a company (Xu & Yang, 2013). The inaccuracy of accounting information reported through earnings management seriously impairs the ability of potential creditors and investors to properly assess the company's prospects and the managerial use of committed funds (Anagnostopoulou & Tsekrekos, 2017). According to the Report to Nations 2024 by the Association of Certified Fraud Examiners (ACFE) (2024), financial statement fraud represents the least common category of occupational fraud, accounting for 5 per cent of reported cases, likely due to the complexity and difficulty involved in committing such fraud. On the other hand, this fraud results in the largest median loss (USD 766,000 per case). Therefore, users of financial statements need to pay greater attention to this manipulative earnings management activity (Association of Certified Fraud Examiners (ACFE), 2024).

Managers potentially employ various earnings management mechanisms, including Real Earnings Management (REM), Accrual Earnings Management (AEM), and Classification Shifting, to achieve desired financial reporting outcomes (Abernathy et al., 2014; Cupertino et al., 2017). Zhu et al. (2015) reveal that managers may prefer one strategy over another depending on the costs and constraints associated with a particular earnings management mechanism. The choice of these earnings management mechanisms can be referred to as an earnings management trade-off.

Several studies also indicate a shift in earnings management

mechanisms employed by managers, especially from AEM to REM (Ali & Kamardin, 2018). This transition is attributed to the relative ease of implementing discretionary decisions and the diminished likelihood of detection by regulatory bodies and auditors. Furthermore, the presence of outside block holdings may exert additional pressure on managers to achieve enhanced firm performance, thereby catalysing this shift (Jumawan-Matero & Liao, 2023). An example of a decision made is as was done by PT Indofarma (Persero) Tbk in the case described previously by inflating inventory (by carrying out overproduction). An example is PT Indofarma (Persero) Tbk's decision to inflate inventory through overproduction.

2.3 Socio-Emotional Wealth Theory

Family-owned firms exhibit distinct characteristics that set them apart from other ownership structures. Specifically, family control and ownership often prioritise a broader range of non-economic objectives, extending beyond the interests of shareholders. This non-economic spectrum encompasses various aspects, including deriving identity from the company, projecting a positive family image and reputation, garnering community recognition, enjoying personal prestige and social standing, and accumulating social capital (Berrone et al., 2010). This concept is referred to as "socioemotional wealth" (Gómez-Mejía et al., 2007).

Socio-emotional Wealth (SEW) refers to the non-financial aspects, such as identity, the ability to utilise family influence, and the preservation of the family dynasty, that fulfil the affective needs of the family (Gómez-Mejía et al., 2007). SEW is considered an inherent characteristic of family businesses (Berrone et al., 2010, 2012; Martínez-Romero & Rojo-Ramírez, 2016). Specifically, SEW is defined as an intrinsic and inseparable aspect that all family businesses share, namely a series of feelings, emotions, relationships, and bonds that bind family members within the company (Martínez-Romero & Rojo-Ramírez, 2016).

Berrone et al. (2010) further state that SEW is an important part of the family business. There is a tendency for family businesses to avoid being denounced as unethical corporations. Public criticism can have an emotional impact on family members, as it potentially damages the family's reputation and standing. The family's identity is closely tied to the business, and visible actions that tarnish the family's reputation can diminish the owner's pride in their family name. Consequently, the adverse perception of the company resulting

from unethical practices like earnings management can serve to "diminish" the socio-emotional wealth.

SEW theory argues that family firms are more committed to maintaining affective endowments of the founding family than non-family firms (Achleitner et al., 2014; Paiva et al., 2016). In this situation, the primary concern of the founding family is to protect the benefits derived from the non-economic aspects of the business. These aspects include maintaining control over the business, perpetuating the family dynasty, and protecting family wealth (Achleitner et al., 2014; Martínez-Romero & Rojo-Ramírez, 2016).

Gomez-Mejia et al. (2011) suggest that EM potentially has several benefits, at least in the short term. These benefits include an increase in stock prices, a decrease in the Market-to-Book Ratio, and a reduction in the risk of takeover. However, despite these benefits, especially for diversified shareholders, family firms tend not to manage earnings and are more likely to provide honest reporting to the public. This tendency arises from family firms' desire to preserve their socioemotional wealth by upholding a positive reputation and projecting favourable images (Gomez-Mejia et al., 2011). The family's reputation and image are of utmost importance, frequently taking precedence over financial goals. As a result, family firms tend to avoid earnings management practices that may compromise their public image or reputation (Sundkvist & Stenheim, 2023). Additionally, family businesses prioritise long-term sustainability, recognising that earnings management can harm the company's prospects, as investors view such practices as unethical (Martin et al., 2016).

It was further revealed that, from the SEW perspective, it is estimated that managers in family firms will be less likely than managers in non-family firms to engage in earnings management actions that consume real resources in the long run, namely REM, to maintain family wealth (Achleitner et al., 2014; Paiva et al., 2016). This is because REM is likely to have a negative impact on the company's future operational performance. The same point was also made regarding the relationship between family firms and AEM; several studies have found that the level of AEM in family firms tends to be lower than in non-family firms.

Recent studies (Jumawan-Matero & Liao, 2023; Sundkvist & Stenheim, 2023) suggest that family firms view earnings management as a "Mixed Gamble." Family firms in Indonesia, where reputational damage is a severe social penalty, are likely to weigh the economic benefits of profit inflation against the potential socio-emotional

wealth (SEW) loss associated with being caught, leading them to favour Real Earnings Management (REM). While REM (e.g., overproduction) harms long-term cash flow, it is "disguised" as a business decision, making it far less likely to be flagged by the OJK or external auditors compared to Accrual Earnings Management (AEM).

2.4 Hypotheses Development

According to the SEW Theory, family businesses operate under a system that prioritises non-economic goals, aiming to preserve the socio-emotional wealth embedded in the company (Berrone et al., 2012; Gómez-Mejía et al., 2007). The socio-emotional wealth encompasses aspects such as family influence, identity, emotional attachment to the firm, and preservation of the family legacy (Berrone et al., 2010; Gómez-Mejía et al., 2007). The preservation of socio-emotional wealth in family firms is deeply ingrained in the psychological dynamics of family owners, which is intricately tied to the organisation's identity (Berrone et al., 2012). Consequently, in family businesses, the erosion of socio-emotional wealth is tantamount to an erosion of identity (Hedberg & Luchak, 2018). Family firms exhibit "loss aversion" when socio-emotional wealth is threatened, leading them to avoid strategies that might jeopardise it, despite potential economic benefits (Zhong et al., 2021, 2022).

Earnings management, an accounting choice, is perceived as a strategic decision to threaten the socio-emotional wealth of the family's firms (Gomez-Mejia et al., 2011). While it may yield short-term gains (Martin et al., 2016), detection leads to economic losses (fines) and non-economic losses (reputational damage) (Achleitner et al., 2014; Ferramosca & Allegrini, 2018; Martin et al., 2016).

Zhong et al. (2021, 2022) found that family firms vary in their prioritisation of socio-emotional wealth preservation. It is generally believed that there will be differences in emotional attachment to the company between the founder and his successor. The founder typically invests significant time, energy, and capital in establishing and growing the family business (Mullins, 2017). This fosters a strong emotional attachment and sense of belonging (Fang et al., 2018). For founders, personal interests and reputation are intertwined with the company, making socio-emotional wealth their most valuable asset (Brune et al., 2019; Strike et al., 2015). Consequently, their strategies prioritise preserving this wealth. Founders serving as CEO or chairman tend to discourage earnings management that harms socio-emotional wealth (Zhong et al., 2021, 2022), instead opting for practices that preserve the company's reputation.

Achleitner et al. (2014) suggested that family firms will do an earnings management trade-off from REM to AEM. The decision was made because REM has a lower detection risk, implying it also reduces the family business's risk of losing its good reputation. Family businesses tend to be more sensitive to reputational risk than to financial losses. Based on the explanation presented, the hypothesis to be tested is as follows:

H_1: *Family firms with a founder serving as CEO will have a higher level of real earnings management*

From the perspective of SEW Theory, although family firms prioritise maintaining control, they may also act more conservatively by avoiding business decisions that could increase performance variability. This perspective allows for the assumption that policymakers do not hold consistent risk preferences and may take a contingency-based view and have varying risk preferences, depending on the context at hand (Wiseman & Gomez-Mejia, 1998; Gómez-Mejía et al., 2007).

Therefore, it is believed that managerial choices in family firms will also consider contingency aspects such as firm hazard or corporate risk (Gomez-Mejia et al., 2011). Based on previous research, it is believed that family companies will be willing to take actions that "threaten" socio-emotional wealth if they face greater performance risks or corporate risks. This is undertaken to prevent further losses that could jeopardise the company's assets, including its socio-emotional wealth (Belda-Ruiz et al., 2022; Gomez-Mejia et al., 2011).

When considering earnings management trade-offs, family firms facing high firm hazard are likely to prioritise mechanisms that increase company value, even if it means higher detection risks, potentially leading to a shift between REM and AEM (or vice versa). Family firms exhibit a heightened concern for maintaining control and preserving socio-emotional wealth (SEW) during the early generational stage or when the founder assumes the role of CEO or chairman (Gomez-Mejia et al., 2011; Gómez-Mejía et al., 2007). However, if it is referred to the founder's desire to ensure the company's survival when facing a high firm hazard situation, then there will be a tendency for the founder, who is also the CEO or director, to make a trade-off decision on earnings management to a mechanism that can ensure that his company can have a going concern. As REM will cause a negative cash flow and can have a negative impact on the company's value in the future, the founder, who also serves as CEO, will tend to avoid it to preserve SEW. Based

on the explanation presented, the hypothesis to be empirically tested is formulated as follows:

H_2: The positive relationship between founder domination and real earnings management will be weaker in high firm risk situations.

The decision to engage in earnings management is not a choice of a single instrument in isolation, but rather a strategic trade-off based on the relative costs and constraints of different mechanisms (Zang, 2012). For family firms, this trade-off is governed by a complex interplay between financial benchmarks and the preservation of Socioemotional Wealth (SEW) (Achleitner et al., 2014), and the relative costs and benefits of both REM and AEM (Cohen et al., 2008; Cohen & Zarowin, 2010; Ewert & Wagenhofer, 2005; Zang, 2012).

The existing literature posits that family firms view AEM and REM as strategic substitutes (Achleitner et al., 2014). While REM (e.g., reducing R&D spending or offering aggressive price discounts) is less likely to trigger auditor scrutiny and thereby safeguard the family's reputation, it imposes a significant long-term economic burden that may compromise transgenerational survival (Ma & Ma, 2024). Conversely, AEM is "cheaper" in terms of cash flow but carries a higher risk of audit qualification and regulatory sanctions, which could tarnish the "Family Face" (Sundkvist & Stenheim, 2023).

In Indonesia's institutional context, marked by paternalistic governance structures and a two-tier board system, the founder's reputation is inextricably linked to the firm's legitimacy. Thus, the substitution represents a survival-based contingency. When the marginal cost of REM becomes prohibitive, particularly during periods of firm hazard where cash preservation is critical, family firms may be compelled to substitute toward AEM to meet earnings targets, despite the inherent detection risks. This inverse relationship suggests that the choice of manipulative tool is contingent upon the prevailing institutional and financial constraints facing the family dynasty.

H_3: Family firms utilise Accrual Earnings Management (AEM) and Real Earnings Management (REM) as strategic substitutes, where the selection of one mechanism is inversely related to the constraints and costs associated with the other.

3. Research Method

3.1 Population and sample

The population of this study comprised public companies listed on

the Indonesia Stock Exchange (IDX). The sample consists of family businesses listed on the IDX, defined as companies meeting the criteria established by Chua et al. (1999) and Suprianto et al. (2019), namely:

1. The family has ownership (>20 per cent) in the company, and/or
2. The presence of family members is observed on the board of directors, board of commissioners, or in top management positions.

This study focused on the manufacturing sector, spanning 2022 to 2024, as this sector provides a more pertinent context for examining real earnings management, particularly regarding abnormal production metrics. Manufacturing companies are those whose business activities process raw materials into finished or semi-finished goods. This study employed the JASICA (Jakarta Stock Industrial Classification) industry classification system, which categorises firms based on their economic activities (Cakranegara, 2022).

3.2 Variables Definitions and Measurements

3.2.1 Earnings Management Trade-off

The dependent variable in this study is the earnings management trade-off. The earnings management trade-off in question is whether to use real earnings management mechanisms instead of accrual-based earnings management, or vice versa. The measurements employed in this study are adopted from Zang (2012), utilising unexpected REM as a proxy to capture the trade-offs inherent in earnings management decisions.

$$REM_t = \alpha + \beta_1 \, Cost\ of\ REM + \beta_2 \, Cost\ of\ AEM + CONTROLS + \varepsilon \quad (1)$$

$$AEM_t = \alpha + \beta_1 \, Cost\ of\ AEM + \beta_2 \, Cost\ of\ REM + \beta_3 \, Unexp\ REM + CONTROLS + \varepsilon \quad (2)$$

To address potential endogeneity between the two forms of earnings management, a recursive system is employed, following Zang (2012). The approach involves a two-stage estimation process: first, "Unexpected REM" is estimated, and subsequently, it is incorporated as a regressor in the AEM model, thereby controlling for the endogenous trade-off decision.

The AEM model also incorporates "Unexpected REM" as a control variable, given that REM typically occurs throughout the fiscal year, whereas AEM often transpires after the fiscal year-end, before earnings reporting (Cunningham et al., 2020; Zang, 2012). This illustrates the sequential decision-making process, wherein firms initially engage in real activities management, followed by accrual manipulation. Therefore, a recursive system of equations is used to capture this decision sequence. Unexpected REM is the residual of equation (1). The negative sign on the coefficient of Unexpected REM in equation (2) will indicate a substitutive relationship between the two earnings management methods (Zang, 2012).

Roychowdhury (2006) mentioned that there are several measures for REM; the first is abnormal cash flow from operations (Abn_CFO). Abn_CFO is obtained from the actual operating cash flow minus the "normal" cash flow calculated using the following formula:

$$CFO_{it} / A_{it-1} = \alpha_0 (1 / A_{it-1}) + \alpha_1 (S_t / A_{t-1}) + \alpha_2 (\Delta S_t / TA_{t-1}) + \varepsilon_t \quad (3)$$

A_t is the total assets at the end of period t, and St is sales of period t, ΔS_t is a reduction in sales for this period (St) with previous period sales (St-1). Cohen et al. (2008) has also formulated a way to calculate normal production costs with the following formula:

$$PROD_t/A_{t-1} = \alpha_0(1/TA_{it-1}) + \alpha_1(S_t/A_{it-1}) + \alpha_2(\Delta S_t/A_{it-1}) + \alpha_3(\Delta S_{t-1}/A_{it-1}) + \varepsilon_t \quad (4)$$

Where PROD is the total cost of goods sold and inventory growth. The third measure is abnormal discretionary expenses. Cohen et al. (2008) has also formulated a way to estimate normal discretionary expenses, namely:

$$DISEXP_t/A_{t-1} = \alpha_0(1/A_{t-1}) + \alpha_1(S_{t-1}/A_{t-1}) + \varepsilon_t \quad (5)$$

REM is measured using the REM_Index. This measurement is adopted from Cohen et al. (2008). It is the sum of the standardised individual components. The formula for REM_Index is standardised Abn_CFO * -1 + standardised Abn_Prod + standardised Abn_Discexp * -1

Meanwhile, abnormal accruals, a proxy for Accrual Earnings Management (AEM), are calculated as the residual from the Modified Jones Model. The model is specified as follows:

$$NDAt = \alpha_1 \left(1/_{At-1}\right) + \alpha_2 (\Delta REVt - \Delta RECt) + \alpha_3 (\Delta PPEt) \quad (6)$$

According to Zang (2012), four variables are posited to influence Real Earnings Management (REM) costs: market share (MS), company health (ZSCORE), institutional ownership (INST), and marginal tax rate (MTR). MS is operationalised as the ratio of a firm's sales to the aggregate sales of its industry. ZSCORE is quantified using the Altman Z-score, a measure of financial distress. INST is measured as the proportion of institutional ownership at the beginning of the year (Cunningham et al., 2020; Zang, 2012). MTR is typically measured as the firm's marginal tax rate, reflecting the tax burden on additional income.

This study differs from the models employed by Cunningham et al. (2020) and Zang (2012), as it omits the marginal tax rate variable, a decision consistent with the approach adopted by Ontorael & Geraldina (2017). The exclusion of MTR from the model is justified by the Indonesian income tax system, which imposes a flat corporate tax rate of 25 per cent (Arnold, 2012), rendering the marginal tax rate concept inapplicable. Thus, the inclusion of MTR as a variable is deemed less relevant in the context of this research setting.

AEM costs include auditor oversight and accounting flexibility. Auditor oversight is proxied by BIG4 (large audit firms) and TENURE (auditor tenure) (Cunningham et al., 2020; Zang, 2012). Accounting flexibility is measured by NOA (net operating assets at the beginning of the year) and Cycle (length of operating cycle), reflecting the extent of prior earnings manipulation.

3.2.2 Founder Domination

Founder domination (FD) refers to the company founder's presence that serves as the CEO well. Following Zhong et al. (2022), FD is measured using a dummy variable, coded 1 if the founder is also the CEO (in family firms), and 0 otherwise.

3.3.3 Firm Hazard

Firm hazard (FH) encompasses business risks that impact a company's performance (Belda-Ruiz et al., 2022; Gomez–Mejia et al., 2014). The measure used is the industry-median-adjusted return on assets (RoA). This benchmark serves as an indicator of a company's performance relative to industry peers. A sample firm exhibiting a high ROA relative to the industry median is interpreted as indicative of lower risk, whereas a low ROA suggests elevated risk (Belda-Ruiz et al., 2022; Gomez–Mejia et al., 2014).

3.3.4 Control Variables

The study incorporates several control variables, namely company profitability, proxied by Return on Assets (ROA); company size, measured as the natural logarithm of total assets; and Market to Book Ratio (MtoB), which controls for the company's growth rate (Zang, 2012).

3.3 Moderated Regression Analysis

Moderated regression is the classification of regression procedures to detect moderation effects (Dunk, 2003; Stone & Hollenbeck, 1984). Allison (1977) argues that to test for the presence of interaction, X1 and X2 are incorporated as explanatory variables in the multiple regression model. The incorporation of both interaction effects and main effects in a moderated regression analysis is commonly referred to as conventional moderated regression (Dunk, 2003; Stone & Hollenbeck, 1984). Moderated Regression Analysis (MRA) is used to test the interaction effect. It is a specific application of Ordinary Least Squares (OLS) that incorporates interaction terms to test how a moderator influences the relationship between the independent and dependent variables (Hartmann & Moers, 1999).

The model used for hypothesis testing is based on research by Zang (2012) and Cunningham et al. (2020). The AEM and REM variables (REM_Index) are associated with the independent and moderating variables after controlling for other factors that influence AEM and REM practices, as stated in the previous section. Accordingly, the research model employed in this study is specified as follows:

$$\begin{aligned}\text{REM\_Index}_t = {} & \alpha + \beta_1 \text{FD} + \beta_2 \text{FH} + \beta_3 \text{FDXFH} + \beta_4 \text{MS} + \beta_5 \text{ZSCORE} + \beta_6 \text{INST} \\ & + \beta_7 \text{BIG4} + \beta_8 \text{TENURE} + \beta_9 \text{NOA} + \beta_{10} \text{CYCLE} + \beta_{11} \text{RoA} \\ & + \beta_{12} \text{LNASSET} + \beta_{13} \text{MTB} + \varepsilon \\ \text{AEM} = {} & \alpha + \beta_1 \text{FD} + \beta_2 \text{FH} + \beta_3 \text{FDXFH} + \beta_4 \text{BIG4} + \beta_5 \text{TENURE} + \beta_6 \text{NOA} \\ & + \beta_7 \text{CYCLE} + \beta_8 \text{MS} + \beta_9 \text{ZSCORE} + \beta_{10} \text{INST} + \beta_{11} \text{UNEXREM} \\ & + \beta_{12} \text{RoA} + \beta_{14} \text{LNASSET} + \beta_{15} \text{MTB} + \varepsilon\end{aligned}$$

Table 1: Measurements of Variables

Variable (Code)	Operational Definition Variable	Measurement
REM_Index	Real Earnings Management	standardised Abn_CFO * -1 + standardised Abn_Prod + standardised Abn_Discexp * -1
AEM	Accrual Earnings Management	$NDAt = \alpha_1 \left(1/At-1\right) + \alpha_2 (\Delta REVt - \Delta RECt) + \alpha_3 (\Delta PPEt)$
FD	Founder Domination	Dummy Variable: 1= Founder serves as CEO 0 = Founder does not serve as CEO
FH	Firm Hazard	Mean-adjusted industry of Return on Assets
MS	Market Share	The ratio of a company's sales to its industry's total sales
ZSCORE	Company's Financial Health	Modified Version of Altman Z-Score
INST	Institutional Ownership	Percentage of Institutional Ownership in the company
BIG4	Audit Quality	Dummy Variable: 1 = The company is audited by Big 4 Auditors and their affiliates 0 = The company is not audited by Big 4 Auditors and their affiliates
TENURE	Audit Tenure	Number of years the company has been an auditor client
NOA	Net Operating Asset	Net operating assets at the beginning of the year
CYCLE	Company's Operating Cycle	Length of the company's operating cycle
RoA	Profitability	Net Income/Total Asset
LNASSET	Company's Size	Natural Logarithm of Total Assets
MTB	Potential growth rate of the company	Current Stock Price / Book Value per Share

4. Results And Discussion

4.1 Total Observation

The sample of this study is a family business from the manufacturing sector in Indonesia. In accordance with the family business category (Chua et al., 1999; Suprianto et al., 2019). A total of 83 family firms

were identified among 188 manufacturing companies in Indonesia based on the JASICA classification. Manufacturing companies are used as samples because the Real Earnings Management measures are more applicable to this sector.

The study period has been extended from two to three years, facilitating a longitudinal analysis via a panel data approach. The addition of the third year enables the incorporation of fixed-effects modelling to account for time-invariant unobserved factors, thereby reducing the risk of omitted variable bias. Table 2 summarises the total observations used as research samples.

Table 2: Total Observations

Manufacturing Companies based on JASICA classification	188
Minus: Not a Family Business	105
Family Business	83
Number of years of observation	3
Total Observation (firm-years)	249

Source: Authors

4.2 Descriptive Statistics

Founder Domination (FD) is defined as the founder of a company who also serves as the CEO of the company (Zhong et al., 2021, 2022). The data reveals that 27 companies remain under the leadership of their founding entrepreneurs. While the other 56 companies are no longer led by their founders but by their founders' families, as can be seen in Table 3 below.

Table 3: Founder Domination in Family Business in Indonesia 5

Founder serves as CEO/President Director	27	32,53%
Founder does not serve as CEO/President Director	56	67,47%

Source: Authors

These findings suggest that the management of family businesses in Indonesia has transitioned to subsequent generations (second, third, and so on), with the founding generation no longer predominantly holding leadership positions. Notable examples of companies remaining under the stewardship of their founding generation include PT. Argha Karya Prima Industry and PT. Alumindo Light Metal Industry. Meanwhile, PT. Indofood CBP

Sukses Makmur Tbk and PT. Martina Berto Tbk exemplify succession to subsequent generations.

Table 4: Firm Hazard in Family Business in Indonesia

	Mean	Median	Minimum	Maximum
Firm Hazard	0,7941	0,2746	-16,4837	8,6235

Source: Authors

Firm hazard (FH) in this context refers to the performance-related business risk incumbent upon the company (Belda-Ruiz et al., 2022; Gomez–Mejia et al., 2014). The proxy used as a measure of FH is the industry-median-adjusted return on assets (RoA). From the family firm sample, the average figure for firm hazard is 0.7941, and the median is 0.2746. The firm hazard variable, like the investor sentiment variable, also exhibits positive skewness. This finding indicates that the sampled companies exhibit a relatively low level of firm hazard, or business risk. In other words, on average, the sample companies have good business risk performance and show high RoA compared to the industry median (Belda-Ruiz et al., 2022; Gomez–Mejia et al., 2014).

4.3 Model Selection

The Fixed Effects (FE) model was considered to account for unobserved firm heterogeneity; however, the Founder Domination (FD) variable is time-invariant, exhibiting constant values within each cross-sectional unit throughout the observation period. In panel data econometrics, the FE estimator is unable to identify the parameters of such variables due to their perfect collinearity with the entity-specific intercepts. Consequently, the Chow and Hausman tests are rendered inapplicable for this model specification. Analysis is therefore restricted to the Common Effect Model (CEM) and the Random Effect Model (REM). The Breusch-Pagan Lagrange Multiplier (LM) test is employed to determine the most appropriate estimation method between these two alternatives.

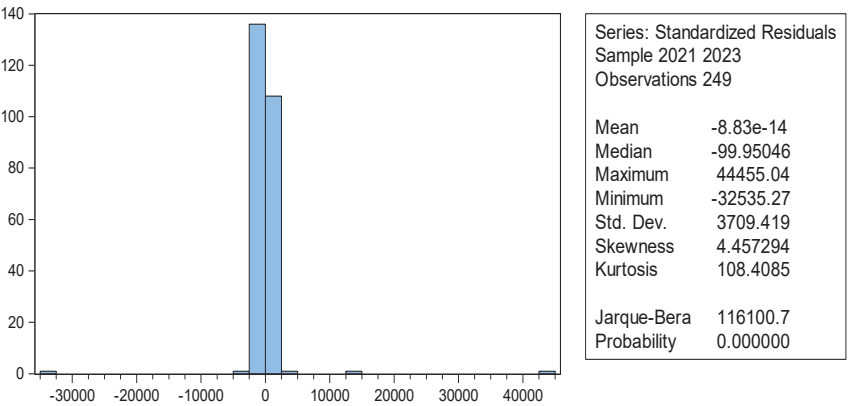
Table 5: Breusch-Pagan Test Result

	Test Hypothesis		
	Cross-Section	Time	Both
Breusch-Pagan	0.086862	1.168682	1.255544
	(0.7682)	(0.2797)	(0.2625)

Based on the Breusch-Pagan Lagrange Multiplier (LM) test, the analysis yielded a cross-section Breusch-Pagan statistic of 0.086862 with an associated p-value of 0.7682. Since the p-value exceeds the 0.05 significance threshold, the null hypothesis—which posits that the pooled OLS (Common Effect) is adequate—cannot be rejected. Therefore, the Common Effect Model (CEM) is deemed more suitable and efficient than the Random Effect Model (REM) for this dataset.

4.4 Classical Assumption Test

Figure 1: Normality Test Result



Statistical testing revealed a p-value of 0.000 (< 0.05), indicating that the residuals deviate from a normal distribution and thus technically violate the normality assumption. However, according to the Central Limit Theorem (CLT), the distribution of the sample mean converges to a normal distribution as the sample size increases ($n \geq 30$), implying the observations are independent and the population has a defined mean and finite variance. The sizable sample employed in this study permits the assumption that the sampling distribution is asymptotically normal, thereby ensuring the robustness of subsequent inferential analyses.

The Breusch-Godfrey Serial Correlation LM test yielded an F-statistic of 3.8140405 with a corresponding p-value of 0.000027. The p-value is below the 0.05 threshold, leading to the rejection of the null hypothesis of no serial correlation, which implies the presence of autocorrelation in the residuals and the violation of the classical linear regression model (CLRM) assumptions.

The Breusch-Pagan Lagrange Multiplier (LM) test yielded a p-value of 0.0000, significantly below the 0.05 threshold. This result indicates the presence of cross-sectional dependence among individuals within the model. This dependence is thus recognised as a limitation, potentially compromising estimation efficiency unless addressed through suitable econometric adjustments. The Glejser test results indicate p-values below the 0.05 significance level for several variables, signifying the presence of heteroskedasticity and, consequently, a violation of the model's homoskedasticity assumption.

The detection of heteroskedasticity, serial correlation, and cross-sectional dependence in the diagnostic phase led to the employment of the Common Effect Model (CEM) estimated via Generalised Least Squares (GLS) with Cross-Section Weights, specifically utilising Panel Corrected Standard Errors (PCSE). This approach was selected as it accounts for complex error structures by allowing for heteroskedasticity across panels and contemporaneous correlation between cross-sections. By utilising GLS-based weighting, the model produces more efficient and consistent parameter estimates compared to ordinary least squares (OLS), ensuring that the resulting statistical inferences are robust against the identified violations of classical linear regression assumptions.

4.5 Result of Hypothesis Testing

Table 6: F-Statistic Test Results

	F-Statistic	Prob (F-Statistic)	
Value	6.975187	0.000000	Model Fit

Source: E-views Output

The test results indicate an F-statistic of 2.239460 with a corresponding p-value of 0.005270, which is less than the 0.05 significance level. Thus, the research model is deemed fit.

Table 7: Hypotheses Testing Results

Variable	**Y = REM**	**Y = AEM**	
FD	141.0682 (0.0304)**	0.331869 (0.0614)	H1 Supported
FD*FH	-0.236561 (0.0002)**	-46.08858 (0.0283)	H2 Supported

Source: E-views Output

The results of the Moderated Regression Analysis (MRA) indicate support for H1, which hypothesised that founder-CEOs are associated with higher levels of real earnings management (REM) (p = 0.0304). Additionally, firm hazard was found to significantly moderate the relationship between founder domination and earnings management trade-off (p = 0.0002).

The EM trade-off is tested using a recursive equation system (equations (1) and (2) in the variable operationalisation section) to capture the sequence of real earnings management and accrual earnings management decisions. This test follows the methodology of Zang (2012). According to Zang (2012), REM is carried out throughout the fiscal year and is realised at the end of the fiscal year, after which managers can adjust the level of AEM based on the impact of the previous mechanism.

$$REM_t = \alpha + \beta_1 Cost\ of\ REM + \beta_2 Cost\ of\ AEM + CONTROLS + \varepsilon \quad (1)$$

$$AEM_t = \alpha + \beta_1 Cost\ of\ AEM + \beta_2 Cost\ of\ REM + \beta_3 Unexp\ REM + CONTROLS + \varepsilon \quad (2)$$

From the test results using equations (1) and (2), it was found that the Unexpected REM coefficient (obtained from the residual of equation (1) has a negative value, as shown in Table 8.

Table 8: Results of Earnings Management Trade-off

Coefficient	Probability	
-0.026300	0.050677	H3 Supported

Source: E-views Output

The coefficient for Unexpected REM is negative (-0.0263) and marginally significant (p≈0.05), providing evidence of a substitutive trade-off between REM and AEM. This result aligns with Zang (2012) and addresses concerns regarding the endogenous relationship between the two earnings management strategies by utilising a recursive structural approach.

4.6 Robustness and Sensitivity Analysis

To ensure the validity of the primary findings and address potential model misspecification, this study conducts a robustness test. This analysis assesses the stability of the core regression coefficients under alternative specifications or subsample partitions (Lu & White, 2014;

Neumayer & Plümper, 2017). Specifically, an ANOVA was conducted to examine differences in Real Earnings Management (REM) and Accrual-based Earnings Management (AEM) across two distinct leadership groups: founder-led firms versus next-generation-led firms.

Table 9: Robustness Test Result

	P-value	Interpretation
REM (*Between Groups*)	0.0313	Statistically Significant
AEM (*Between Groups*)	0.0117	Statistically Significant

As shown in Table 9, the results indicate significant differences in earnings management trade-off decisions between founder-led and next-generation-led family firms. The p-values for both REM ($p < 0.05$) and AEM ($p < 0.05$) confirm that leadership heterogeneity exerts a contingent effect on earnings management behaviour. These findings are consistent with the primary hypothesis testing, further validating that the generational stage of the family firm is a critical determinant of financial reporting quality.

4.7 Discussion

The statistical results confirm the robustness of the framework. The model yields an Adjusted R-squared of 0.323, indicating that over 32 per cent of the variation in Real Earnings Management (REM) among Indonesian family firms is explained by the interaction of founder domination and firm hazard. This high explanatory power, coupled with a highly significant F-statistic (7.989, p=0.000), justifies the adoption of a moderated approach over a simple OLS model.

The findings indicate that family firms with founder-CEOs or those with higher levels of founder domination exhibit significantly higher levels of Real Earnings Management (REM). This is consistent with Socioemotional Wealth (SEW) Theory, which posits that founders' profound emotional attachment to the firms they established (Fang et al., 2018; Mullins, 2017), influences their decision-making. Additionally, founders possess more socio-emotional wealth than subsequent generations. Consequently, decisions made by founder-CEOs are more likely to prioritise preserving this wealth (Brune et al., 2019; Strike et al., 2015). Thus, they will tend to implement earnings management mechanisms that balance reputational risk and long-term value.

While AEM carries a higher detection risk from regulators, REM

involves manipulating actual operations, which, although more opaque to external observers, compromises future cash flows (Zhong et al., 2022). This decision stems from the founders' perception of the firm as an extension of their personal identity, prioritising the preservation of SEW and the company's reputation. Consequently, founders favour REM over Accrual Earnings Management (AEM) when they believe it better ensures the firm's longevity, a defining characteristic of family-led enterprises (Haag et al., 2023).

In the Indonesian context, the preference for REM among founder-led firms is deeply tied to the concept of social capital. Within Indonesian business circles, a family's reputation is a vital asset for securing credit and maintaining business group ties. Since Accrual Earnings Management (AEM) is subject to stricter scrutiny by the regulator and external auditors, founders often pivot toward REM. Founders achieve financial targets with lower detection risk by manipulating operational activities. This allows them to preserve the family's public image and the firm's socioemotional wealth simultaneously.

However, this behaviour is contingent upon the firm's stability. Our results show that Firm Hazard (FH) acts as a critical moderating variable, weakening the positive relationship between FD and REM. Essentially, when business risks intensify, the priority shifts from preserving immediate SEW to ensuring the firm's survival as a going concern (Belda-Ruiz et al., 2022). Gomez–Mejia et al. (2014) revealed that family firms generally try to balance the potential advantages and disadvantages in the socio-emotional and financial wealth domains when making strategic decisions related to the firm, such as those related to EM and its trade-off mechanisms.

The strategic decision between maintaining financial or socio-emotional wealth will depend greatly on the firm's context (Belda-Ruiz et al., 2022; Cambrea et al., 2022). For instance, when facing high business risks, family companies prioritise maintaining sound financial conditions, thereby ensuring the preservation of socio-emotional and financial wealth for subsequent generations (Cambrea et al., 2022; Gomez-Mejia et al., 2018). Clemente-Almendros et al. (2024) asserted that the founder generation has a desire to pass on their idea of a "healthy company" to the younger generation and maintain the family name and the work of the founder, as well as the company's value in the future (Comino-Jurado et al., 2021). The findings suggest that Indonesian founders demonstrate pragmatic tendencies. When the firm faces an existential threat (High Firm Hazard), the cultural priority of ensuring longevity prevails,

prompting it to prioritise the business's survival and its transmission to subsequent generations.

Finally, the evidence indicates a substitution effect (H3) among Indonesian family firms. Managers engage in a trade-off between REM and AEM, predicated on a cost-benefit analysis (Abernathy et al., 2014). Consistent with Achleitner et al. (2014), Indonesian family firms exhibit a propensity to pivot away from REM when it jeopardises future firm value, instead opting for AEM to maintain a balance between financial viability and family legacy.

5. Conclusions and Implications

The results reveal that founder domination in Indonesian family firms, specifically when the founder occupies the CEO position, is positively associated with the use of Real Earnings Management (REM). It provides strong empirical support for Socioemotional Wealth (SEW) Theory, suggesting that founders prioritise preserving their emotional attachment and family reputation. Furthermore, the results show that firm hazard (FH) weakens the relationship between founder domination and REM. In the context of this study, high business risk will encourage family companies led by founders to maintain their business (going concern) by choosing the earnings management mechanism that prioritises capital preservation over short-term reputation smoothing. This is consistent with the socioemotional wealth theory posited by Gomez-Mejia et al. in 2014 and 2018. In addition, the statistical robustness of this model is evidenced by an Adjusted R-squared of 32.4 per cent and a Durbin-Watson of 2.018, indicating that the interaction between founder domination and firm hazard offers significant explanatory value for earnings management decisions in the Indonesian capital market.

This study enriches the literature on earnings management trade-offs by demonstrating that the choice between AEM and REM is not static but contingent upon the firm's hazard level. In the unique context of Indonesia, where ownership is highly concentrated, this study reveals that cultural values, notably the preservation of reputation and emphasis on longevity, exert a significant influence on the quality of financial reporting. It provides a nuanced view of SEW theory, showing that "wealth" is redefined from emotional assets to financial survival when existential risks are high.

The research findings also yield several practical implications. Notably, professional associations, such as Ikatan Akuntan Indonesia (IAI), and regulatory bodies, including Otoritas Jasa Keuangan (OJK) and Bursa Efek Indonesia (BEI), can utilise these results to further

refine financial accounting standards, thereby mitigating managerial discretion that precipitates manipulative earnings management practices. Another practical implication pertains to stakeholders. The findings empower stakeholders of Indonesian family businesses to strengthen internal monitoring mechanisms, thereby enhancing financial reporting transparency. This, in turn, is likely to improve financial report quality, as reflected in reduced manipulative earnings management, and ultimately facilitate more informed financial decision-making.

The primary focus of this study is the founder generation. Future researchers are encouraged to expand this context by comparing family and non-family companies or investigating whether second-generation (descendant) leaders maintain the same "survival-first" pragmatism as their predecessors. Future research examines whether affiliations with specific business groups in Indonesia amplify the use of REM to safeguard the broader conglomerate's reputation.

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