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# Financial Statement Fraud Risk and Financial Distress of Family Business: Socio-Emotional Wealth (SEW) Perspective

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**Abstract**

This study examines the risk of financial statement fraud in family businesses and explores financial distress as a moderating variable. The research sample consists of 306 businesses in Indonesia. The findings reveal that family businesses in Indonesia tend to avoid fraud to protect their family reputation, consistent with the Socio-Emotional Wealth (SEW) theory. However, financial distress is also found to mitigate the negative effects of family ownership on the risk of financial statement fraud. Furthermore, the results indicate no significant difference between the first and second-generation controllers in their attitudes towards the risk of financial statement fraud, aligning with the SEW theory. This research contributes to the accounting literature by providing insights into the unique dynamics of family businesses, particularly in the context of financial distress. It highlights the importance of considering both family ownership and financial conditions when assessing the risk of fraud. These findings are valuable for family business owners, policymakers, and practitioners, offering guidance on maintaining business value and implementing effective governance policies to prevent financial statement fraud.

**Keywords**: socio-emotional wealth; financial statement fraud; financial distress; family business

## INTRODUCTION

Fraud is a pervasive issue in the business world, leading to significant financial losses and eroding market stability and investor confidence. The Association of Certified Fraud Examiners (ACFE) reports that businesses, on average, lose 5% of their revenues to fraud. In a study of 2,504 cases, total losses amounted to 3.6 billion dollars, with the average loss per case being 1.5 million dollars.

Fraud in businesses can be classified into three main categories: asset misappropriation, corruption, and financial statement fraud. Although financial statement fraud is less common than the other types, it is associated with the most substantial financial losses. This form of fraud involves the deliberate misrepresentation of financial information, aimed at deceiving stakeholders about the true financial health of a company.

Financial statement fraud typically involves overstating assets, revenues, and profits, or understating liabilities, expenses, and losses. These manipulations lead investors to form a misguided perception of the firm's value, which can result in severe consequences for the company and the broader market. High-profile cases such as the Enron scandal illustrate how financial statement fraud can lead to catastrophic loss of investor trust and market destabilization. In the context of Indonesia, where family businesses are prevalent, the issue of financial statement fraud is particularly significant.

The Fraud Triangle theory, proposed by Donald Cressey, offers a framework for understanding why fraud occurs. According to this theory, three elements must be present for fraud to take place: pressure, opportunity, and rationalization. Financial distress serves as a significant pressure, often pushing companies to commit fraud in an attempt to meet financial obligations or expectations. This framework is especially relevant for family businesses, where financial pressures often intersect with unique familial dynamics and relationships.

Family businesses are those owned, controlled, and managed by one or more families. In Indonesia, these businesses are overwhelmingly dominant, accounting for over 95% of companies in the corporate sector. These enterprises often face intricate dynamics, where family interests are closely intertwined with business operations. While agency theory suggests that family businesses can effectively control agency costs due to the alignment of interests between owners and managers, it does not fully account for the complexities and conflicts that can arise within family businesses, which can significantly impact performance. Dyer (2006) notes that these conflicts necessitate special considerations to align interests and enhance business performance.

Socioemotional Wealth (SEW) theory provides a deeper understanding of family business behavior by highlighting the importance of non-economic goals such as family reputation, identity, and control. Research indicates that family businesses often prioritize maintaining a positive family image and long-term control, which influences their approach to financial reporting. Studies conducted in Europe have shown that family businesses frequently report higher earnings quality to preserve their reputation and control (Achleitner et al., 2014; Pazzaglia et al., 2013; Stockmans et al., 2010). In Indonesia, where family businesses are particularly prominent, the interplay between financial distress and the desire to maintain socioemotional wealth can affect the likelihood of engaging in financial statement fraud.

There is a debate in the literature regarding the propensity of family businesses to commit fraud. Some studies suggest that family businesses are less likely to engage in fraudulent activities due to their long-term orientation and concern for family reputation (Tong, 2008). However, other studies argue that the concentration of power within family businesses can lead to misbehavior (Anderson, Martin, and Reeb, 2017; Tong, 2008). Family managers may prioritize their personal wealth over the interests of minority shareholders, potentially leading to fraudulent activities. For instance, Anderson, Martin, and Reeb (2017) found that family businesses are three times more likely to commit financial misrepresentation.

From an auditor's perspective, Krishnan and Peytcheva (2019) indicate that family businesses pose higher risks due to related party transactions and weak internal controls. This study aims to explore the relationship between family businesses and financial statement fraud in Indonesia. Given the high public scrutiny and governmental support for family businesses in Indonesia, this study employs SEW theory to hypothesize that family businesses will avoid financial statement fraud to protect their long-term viability and reputation. Furthermore, it examines how financial distress moderates the relationship between family businesses and the risk of fraud.

By focusing on the intersection of family business dynamics, financial distress, and fraud risk, this study aims to contribute to a deeper understanding of how family firms in Indonesia navigate the pressures that can lead to financial statement fraud. This nuanced exploration will help shed light on the unique challenges and strategies of family businesses in maintaining financial integrity while dealing with internal and external pressures.

## LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT

Theories on family business and frauds rely on two different point of views which are entrancement and alignment. Entrenchment refers to the scenario where family members in control of the business use their power to benefit themselves at the expense of other shareholders. This behavior often leads to inefficient decision-making and can increase the risk of fraud as family members seek to preserve their control and benefits. Entrenched family managers might engage in actions like misreporting financial statements to maintain their position or conceal poor performance. Alignment represents the perspective where the interests of family owners and other stakeholders are closely aligned, typically resulting in better governance and less fraudulent behavior. In this view, family businesses prioritize the long-term health and reputation of the firm, aligning their goals with those of the shareholders and ensuring transparent and ethical business practices.

The agency theory commonly supports the entrenchment perspective, while SEW has a similar perspective to the alignment view of the relationship between family business and frauds. However, SEW has more complex views about the family business which are not limited to financial ties between principles and owners, but also psychological and emotional aspects of family values. In general, SEW could be assumed to support an alignment view.

### Agency Theory

Jensen and Meckling (1976) characterize an agency relationship as a contract between one or more individuals (as principals) who utilize other individuals (as specialists) to perform work on behalf of the central which incorporates giving decision-making specialist to the agent. Agency problems arise when there is a conflict of interest between the agent and the principal. This agency problem is called a type 1 agency problem. However, in 2002, Fan and Wong found another agency problem between majority shareholders and minority shareholders or what is called the agency type problem. 2.

The type 2 agency problem usually occurs in companies that have concentrated shares such as in Indonesia, which are also mostly family companies. Agency theory in family companies' interfaces organization hypothesis and charitableness, benevolence could be a moral esteem that spurs a individual to require activities that advantage others emerging from essential human character through ethical instruction and prove of confidence in God. (Schulze et al., 2003).

Agency theory traditionally focuses on conflicts of interest between principals (owners) and agents (managers), known as type 1 agency problems (Jensen and Meckling, 1976). In family businesses, however, type 2 agency problems often arise, where the conflicts are between majority shareholders (family members) and minority shareholders. Family members may prioritize personal or familial gains, leading to potential misuse of resources and conflicts with non-family shareholders.

While agency theory provides a framework for understanding these conflicts, it does not fully account for the unique non-economic goals and emotional factors that drive family businesses. This gap is addressed by Socioemotional Wealth (SEW) theory, which emphasizes that family firms value not only financial performance but also non-economic goals such as family identity, legacy, and control (Gomez-Mejia et al., 2007). SEW theory posits that family businesses are motivated to preserve their socioemotional wealth, influencing their decision-making processes and behaviors, including their approach to financial reporting and fraud.

Gomez- mejia et al. (2007) stated that the main objective of family enterprises is non-economic goals (good family name). This goal is called socioemotional wealth (SEW).

**Socioemotional Wealth (SEW)**

Based on agency theory, the socioemotional wealth theory (SEW) was developed by Gomez-mejia et al. (2007). This theory predicts that the family owner may be a " misfortune unwilling " and gives more significance to SEW. Gomez- mejia et al. (2007) expressed that an vital perspective of the socioemotional riches of a family firm is the fulfillment of needs related to family recognizable proof such as control and family great title. A family firm could be a combination of two collaboration frameworks, namely an sincerely arranged family framework with the most objective being non-economic and a results-oriented trade framework with the most objective being economic (Distelberg, 2009).

Cennamo et al., (2012) stated that when the main objective is social wealth (SEW), the company's decisions are based on; (a) the values that exist in the family, (b) strong ties between families, (c) the owner's emotional closeness to the company so that management will involve all stakeholders. The five dimensions of social wealth theory (SEW) are Family, Identification, Binding, Emotional, Renewal (FIBER). Socioemotional wealth (SEW) has family control and impact, family recognizable proof with companies, social ties, enthusiastic connection, recharging of family ties with companies through the family dynasty (Berrone et al, 2012).

**Fraud Triangle Theory**

The Fraud Triangle theory is a theory used to reveal the components that influence an act of fraud. Cressey (1953) shows that three elements motivate fraud known as the fraud triangle theory, namely pressure, opportunity, and rationalization. which causes unethical actions caused by both financial and non-financial pressures, one of which is financial distress, which is a factor that causes unethical actions caused by financial and non-financial pressures.

Understanding the Fraud Triangle is crucial for identifying the conditions under which fraud is likely to occur. In family businesses, the unique pressures of maintaining family control and reputation, combined with potential opportunities due to familial dominance in management, can create an environment conducive to fraudulent behavior. The rationalization component may be influenced by family values and norms, further complicating the ethical landscape.

**Family Business and Fraud Financial Statement**

The SEW theory states that the owner of a family firm prioritizes SEW over business goals (company profits). Family business tend not to take risks when the family-owned SEW is not disturbed, on the other hand, family firm owners will take risks when the family-owned SEW is disturbed (Gomez-mejia et al., 2007). Even, according to Cennamo et al. (2012) family companies try to protect family SEW by avoiding risky decisions even though these are economically profitable for the company.

SEW theory informs the hypothesis development by suggesting that family businesses prioritize long-term reputation and socioemotional wealth over short-term financial gains. This perspective helps explain why family businesses might avoid fraudulent financial reporting, even under financial distress, to protect their legacy and maintain trust with stakeholders.

Previous research on financial statement fraud supports this view. Pazzaglia et al. (2013) found that family businesses in Europe are less likely to engage in earnings management to maintain their socioemotional wealth, such as family reputation and control. These findings underscore the importance of SEW in shaping family business behavior and provide a foundation for hypothesizing that Indonesian family businesses, driven by similar motivations, would avoid financial statement fraud.

Previous research of financial statements fraud in times of financial distress in Indonesia is done by (Ghazali et al., 2015; Habib et al., 2012; Kartikasari and Irianto, 2010). Most of this research shows that financial distress has a positive effect on financial statement fraud, including research in Italy by Bisogno and De Luca (2015), in Kenya by Julius (2016), in Malaysia by Arshad et al. (2015), the Enron case by Mahama (2015) and the case in Taiwan by Lou and Wang (2009) and Liou (2008). However, does this apply to family companies according to SEW theory when they want to keep their family's good name.

Integrating findings from Pazzaglia et al. (2013), it becomes evident that the socioemotional wealth perspective is crucial for understanding financial transparency and fraud prevention in family businesses. Pazzaglia et al. (2013) demonstrated that European family businesses, prioritizing their socioemotional wealth, reported better earnings quality to preserve their reputation and control. These results align with SEW theory, suggesting that family businesses in Indonesia may also avoid fraudulent financial practices to protect their socioemotional wealth. Likewise in Indonesia, Indonesian companies (families) who take control of their companies tend not to disappoint stakeholders by providing quality financial reports (Hofstede, 2001).

**Hypotheses**

We formulate the hypotheses for this study as follows:

H1a: Family business has a negative effect on fraudulent financial statements

H1b: Financial distress weakens the negative effect of family business on fraudulent financial statements

H2a: First generation who is the controller is negatively related to the fraudulent act of financial statements

H2b: Financial distress weakens the negative influence of the first generation controlling the fraudulent act of financial statements

H2c: Second generation who is the controller is positively related to the fraudulent act of financial statements

H2d: Financial distress reinforce the positive influence of the second generation controlling the fraudulent act of financial statements

**METHOD**

This study uses a population of family companies listed on the Indonesia Stock Exchange. The research period is 2017-2019. This study uses purposive sampling in determining the sample used in this study. The criteria used by researchers are:

1. Publication of audited financial reports published on the IDX website and/or company websites in 2017, 2018, and 2019.
2. Companies that are classified as financial companies will be excluded from the sample because they have different characteristics from other industries.
3. The company has the data needed in research calculations.
4. Final sample is 306 firm years from 102 firms for 2017-2019 period.

**Method of Analysis**

Hypothesis testing is carried out using the moderated regression analysis (MRA) facility or interaction test using the interaction element of multiplying two or more independent variables, namely between the independent and moderated variables (Liana, 2009; Izzalquny, 2019). Testing using data analysis was carried out in several stages, namely as follows (Damiti, 2018); (1) Analyzing the research regression model by including the independent variable and the dependent variable; (2) Analyzing the research regression model by including the independent variable, moderation as independent, and dependent variable; (3) Analyze the research regression model by including the independent variable, the moderating variable as independent, and the interaction between the independent and moderating (MRA) and dependent variables.

The equation of the statistical form of moderation testing with the model:

a. Y = α + ß1.X1 + €. ……model 1
b. Y = α + ß1.X1 + ß2.X2 + ß3.X1.X2 + € ………… model 2
c. Y = α + ß1.X3 + €. …….model 3
d. Y = α + ß1.X3 + ß2.X2 + € + ß3.X3.X2 …………….. model 4
e. Y = α + ß1.X4 + €. ….. model 5
f. Y = α + ß1.X4 + ß2.X2 + € + ß3.X4.X2 ………………. model 6

Information:
Y = Risk of fraudulent financial statements
α = Constant
ß1, ß2, ß3, ß4 = regression coefficients
X1 = Family business
X2 = Financial distress
X3 = The first generation of controllers
X4 = Second generation of controllers
€ = Error

The results of F-Score (Hung et al., 2017): F-score > 2.45 is very high risk; F-score > 1.85 is high risk; F-score > = 1 risk above the normal level, and F-score < 1 risk normal or below.

## RESULTS AND DISCUSSION

### Results of Regression Analysis and Hypothesis Testing

The results of the regression analysis were carried out using 12 research models. Model 1 is used to test hypothesis 1a, model 2 is used to test hypothesis 1b, model 3 is used to test hypothesis 2a, model 4 is used to test hypothesis 2b, model 5 is used to test hypothesis 2c, model 6 is used to test hypothesis 2d, model 7 used to test hypothesis 3a, model 8 is used to test hypothesis 3b, model 9 is used to test hypothesis 3c, model 10 is used to test hypothesis 3e, model 11 is used to test hypothesis 3e, and model 12 is used to test hypothesis 3f. The result was adjusted to one-tailed output result is worth two-tailed, with the test results and the regression coefficient determination shown in Table 1.

This study consists of three hypotheses and the results show that, firstly, Hypothesis 1a which states that family business has a negative effect on fraudulent financial statements is tested by looking at model 1 in table 2. The value of the coefficient and t-test of KK (family business) is positive, namely the coefficient of -0.177 with the t-test value of -2.518 with a significance of 0.007 (0.007 <0.05, so it is significant). This shows that there is a negative effect of family business on fraudulent financial statements so that H1a is accepted.

Next, hypothesis 1b which states that financial distress weakens the negative effect of family business on fraudulent financial statements is tested by looking at model 2 in table 2. The value of the coefficient and t-test of MOD (Moderation) is positive, namely a coefficient of 0.137 with a t-test value of 2.082 with a significance

**Table 1. Regression Test Results and Coefficient of Determination**

| Variable | Beta Coefficient | T Test | Sig. | Adj $R^2$ | Examination |
|---|---|---|---|---|---|
| KK | -0,177 | -2,518 | 0,007** | 0,078 | Hipotesis 1a |
| MOD | 0,137 | 2,082 | 0,021* | 0,123 | Hipotesis 1b |
| KK | 0,298 | 0,928 | 0,826 | 0 | Hipotesis 2a |
| MOD | 0,241 | 2,319 | 0,013* | 0,090 | Hipotesis 2b |
| KK | -0,043 | -0,174 | 0,568 | 0 | Hipotesis 2c |
| MOD | 0,182 | 2,960 | 0,002** | 0,045 | Hipotesis 2d |

of 0.021 (0.021 <0.05, so it is significant). This shows that there is financial distress that weaken the negative effect of family business on fraudulent financial statements so that H1b is accepted.

Hypothesis 2a which states that the first generation who is the controller is negatively related to the fraudulent act of financial statements is tested by looking at model 3 in table 2. The value of the coefficient and t-test of KK (family business) is positive, namely a coefficient of 0.298 with a t-test value of 0.928 with a significance of 0.826 (0.826> 0.05 so it is not significant). This shows that there is no negative influence from the first generation to control the fraudulent act of financial statements so that H2a is rejected.

Hypothesis 2b which states that financial distress weakens the negative influence of the first generation controlling the fraudulent act of financial statements is tested by looking at model 4 in table 2. The value of the coefficient and t-test of MOD (Moderation) is positive, namely a coefficient of 0.241 with a t-test value of 2.319 with a significance of 0.013 (0.013 <0.05, so it is significant). This shows that there is an influence of financial distress that weakens the negative influence of the first generation which becomes the controller with fraudulent financial statements so that H2b is accepted.

Hypothesis 2c which states that the second generation who is the controller is positively related to the fraudulent act of financial statements is tested by looking at model 5 in table 2. The coefficient and t-test values of KK (family business) are negative, namely the coefficient of -0.043 with the t-test value of -0.174 with a significance of 0.562 (0.562> 0.05 so it is not significant). This shows that there is no second-generation positive influence which is the controller of fraudulent financial statements so that H2c is rejected.

Hypothesis 2d which states that financial distress reinforces the positive influence of the second generation controlling the fraudulent act of financial statements is tested by looking at model 6 in table 2. The value of the coefficient and t-test of MOD (Moderation) is positive, namely a coefficient of 0.182 with a t-test value of 2.960 with a significance of 0.002 (0.002 <0.05 so it is significant). This shows that there is an influence of financial distress which strengthens the positive influence of the second generation who is the controller of fraudulent financial statements so that H2d is accepted.

For the test results of the coefficient of determination, based on table 2, it is found that the most predictive model is model 2 which predicts financial distress weakening the negative influence of family business on fraudulent financial statements with independence can answer 12.3% of the risk of financial statement fraud and 87, 7% from outside the research model.

## Discussion

*Family business against fraudulent financial statements*

The theory of Socioemotional Wealth (SEW) states that family business owners prioritize the preservation of their family's SEW over the business's economic goals (Gomez-Mejia et al., 2007). Family businesses tend to avoid taking significant risks unless the family's SEW is threatened. In practice, this means that family businesses strive to protect their SEW by avoiding decisions that, while potentially economically beneficial, could jeopardize their family's reputation and values (Cennamo et al., 2012).

This study supports the SEW theory, showing that family businesses are less likely to engage in fraudulent financial reporting. Even in the face of financial distress, family businesses avoid fraudulent activities to maintain their family's good name. This behavior aligns with previous findings that financial distress often increases the risk of fraudulent financial reporting, as seen in studies conducted in Italy (Bisogno & De Luca, 2015), Kenya (Julius, 2016), Malaysia (Arshad et al., 2015), and Taiwan (Lou & Wang, 2009; Liou, 2008), as well as in the Enron case in the United States (Mahama, 2015) and Indonesia (Kartikasari & Irianto, 2010).

However, our findings reveal that financial distress can moderate the relationship between family businesses and fraudulent financial reporting. Family businesses with high SEW are generally committed to high-quality financial reporting to preserve their family identity and reputation (Pazzaglia et al., 2013). The Fraud Triangle Theory further explains these findings: financial distress creates pressure, one of the key elements that can lead to fraud, but the presence of family ownership provides a rationalization factor that prevents fraudulent financial reporting. Hence, even under financial distress, the SEW-driven desire to protect the family's reputation outweighs the temptation to engage in fraud.

*The Influence of Controller Generation on Financial Statement Fraud*

This study found no significant difference in the propensity for fraudulent financial reporting between first-generation and subsequent-generation controllers of family businesses. However, financial distress increases the risk of fraudulent reporting, a finding that does not fully align with SEW theory. SEW theory posits that first-generation controllers, who have a stronger attachment to the family's SEW, are less likely to engage in fraudulent activities compared to subsequent generations (Berrone et al., 2012).

Interestingly, while family businesses overall tend to avoid fraud, the separation of generations does not significantly influence this tendency. This indicates that the SEW theory, particularly the dimension of generational succession, may not fully apply in the Indonesian context. Previous research suggests that family businesses prioritize SEW over other interests, but this focus tends to weaken in later generations. Second-generation controllers may be more focused on economic goals and less on maintaining the family's SEW, potentially increasing the likelihood of fraud (Schulze et al., 2003).

Contrary to expectations, the study found that generational differences do not significantly affect fraudulent financial reporting in Indonesian family businesses. This suggests a uniform commitment to maintaining the family's good name across generations, reinforcing the negative impact of financial distress on the likelihood of fraud. These results support previous studies, including those by Bisogno and De Luca (2015), Julius (2016), Arshad et al. (2015), Mahama (2015), Kartikasari and Irianto (2010), Lou and Wang (2009), and Liou (2008), which all emphasize the heightened risk of financial statement fraud during periods of financial distress.

The influence of financial distress as a moderating factor is particularly noteworthy. Financial distress not only increases the overall risk of fraudulent financial reporting but also affects how different generations within family businesses respond to such pressures. For first-generation controllers, the intrinsic value placed on SEW means they remain less likely to engage in fraud, as they prioritize the family's long-term reputation. Conversely, second-generation controllers may experience a dilution of SEW values, making them more susceptible to fraudulent activities when under financial stress.

## CONCLUSION, IMPLICATION AND LIMITATION

This study investigates the intricate relationship between family businesses and the propensity for financial statement fraud within the context of Indonesia, employing the Socioemotional Wealth (SEW) theory as its theoretical foundation. The findings reveal that family businesses, generally motivated by a desire to preserve their legacy and reputation, exhibit a lower tendency towards fraudulent financial reporting compared to non-family businesses. This proclivity is linked to their long-term orientation and the intrinsic value placed on family reputation. However, the study uncovers that financial distress can significantly erode these ethical commitments, increasing the likelihood of financial misconduct even among family-controlled firms. A noteworthy dimension of the study is the exploration of generational differences, where it is found that first-generation controllers demonstrate a stronger aversion to fraud compared to second-generation controllers, especially when confronted with financial distress. This generational divergence underscores a potential shift in values and priorities as control transitions from the founding to subsequent generations.

The implications of these findings are multifaceted, suggesting that regulators, auditors, and family business owners need to account for the unique pressures and dynamics inherent in family businesses when assessing fraud risk. Specifically, the findings underscore the critical importance of robust governance structures and stringent internal controls to mitigate fraud risk, particularly during periods of financial turmoil. However, the study's scope is not without limitations. The exclusive focus on Indonesian family businesses raises questions about the generalizability of the findings to other cultural and economic contexts. Additionally, the potential influence of confounding variables that were not accounted for in the study could affect the results, and the cross-sectional nature of the data limits the ability to draw causal inferences.

Despite these limitations, the study makes significant contributions to the theoretical discourse by extending the application of SEW theory into the domain of financial fraud. It highlights how the SEW priorities, such as preserving family control and influence, can be compromised under severe economic pressures, leading to ethical lapses. The generational aspect further enriches the SEW theory by suggesting that as family businesses evolve, their socioemotional priorities may shift, influencing their ethical behavior.

To enhance the robustness and applicability of the findings, future research should aim to address these limitations through several approaches. Comparative studies across different cultural and economic contexts could provide a broader understanding of the relationship between family businesses and financial fraud. Employing longitudinal research designs would help in establishing causality and observing how family businesses' commitment to ethical reporting evolves over time. Additionally, exploring other potential moderators and mediators, such as the role of external advisors or the impact of family governance practices, could offer deeper insights. Qualitative approaches, such as in-depth case studies or interviews, could also provide a richer understanding of the internal family dynamics and the decision-making processes that influence financial reporting practices.

Overall, while this study offers significant insights into the interplay between financial distress, family business dynamics, and the risk of financial reporting fraud, addressing its limitations and expanding future research directions will be crucial in enhancing the robustness, generalizability, and practical relevance of the findings.

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