# CHAPTER I

# INTRODUCTION

## *1.1 INTRODUCTION*

Conservatism's influence on accounting practice has been both long and significant[1]. Basu (1997) argues that conservatism has influenced accounting practice for at least 500 years and defines conservatism as the accountant's tendency to require a higher degree of verification when recognizing good news in earnings than for recognizing bad news. Sterling (1970) notes conservatism as the most influential principle of valuation in accounting. Holthausen and Watts (2003a) argue that conservatism is the differential verifiability required for the recognition of accounting gains versus losses that generates understatement of net assets. Conservatism is potentially useful with respect to controlling shareholders in two ways. First, in compensation contracts, conservatism reduces the likelihood that a manager (who is usually the founder or a descendant) will exert the effort to overstate net assets and cumulative earnings in order to distribute the net assets of the firm to themselves instead of exerting effort to take positive net present value projects (Watts, 2003a). Second, in corporate governance, conservatism provides timely signals for investigating the existence of negative net present value projects and taking appropriate action if they exist. Asymmetric verification speeds up the recognition of losses and provides minority shareholders with a signal to investigate the reasons for those losses. Therefore, conservative financial reporting is a governance mechanism

[1] Accounting conservatism is a part of earnings attributes. Francis et al., (2004) characterize earnings attributes as either "accounting-based" or "market-based". Accounting-based consists of accrual quality, persistence, predictability, smoothness. Market-based consists of value relevance, timeliness, and conservatism.

that reduces the controlling owner's ability to manipulate and overstate financial performance and increases the firm's cash flow and value. Controlling shareholders are likely to provide managers with greater opportunity to use less conservative (or aggressive) accounting[2]. Thus, the purpose of this study is to examine whether the accounting conservatism is reduced, *ceteris paribus*, when the controlling shareholder ownership is higher.

When ownership is diffused to shareholders who are not family related, as is typical in US and UK companies, agency problems arise from the conflicts of interest between shareholders and managers who own an insignificant amount of equity in the firm (Berle and Means, 1932; Jensen and Meckling, 1976). With regard to the agency problem, conservatism has been hypothesized to facilitate efficient contracting between managers and shareholders. However, when ownership is concentrated to a level at which an owner obtains effective control of the firm, as is often the case in East Asia and most other locations outside the US and the UK, the nature of the agency problem shifts away from manager-shareholder conflicts to conflict between the controlling owner (who is also the manager) and minority shareholders (Fan and Wong, 2002). Therefore, the problem of efficient contracting between managers and shareholders is moved to the problem between the controlling shareholder and minority shareholders.

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[2] Ball et al., (2000) argue that the opposite of aggressiveness, accounting conservatism, which is the more timely incorporation of economic losses versus economic gains into accounting earnings, arises to reduce information asymmetry. Specifically, they argue that three factors are expected to lead to accounting conservatism. First, accountants are aware that managers would like to report economic gains and suppress information about economic losses. Hence, accountants find negative information more credible, and are more likely to incorporate it into accounting income. Second, lenders are important users of financial statements, and lenders are more affected by economic losses then by economic gains. Third, the timely incorporation of economic losses provides an important corporate governance role, providing quick feedback about bad investment decisions and strategies that managers may not wish to disclose.

Controlling shareholder ownership could affect accounting conservatism reporting in one of two competing ways: the entrenchment effect and the alignment effect. The entrenchment effect motivates financial statements which are prepared by controlling shareholders to opportunistically manage higher earnings. It is consistent with the traditional view that controlling shareholders are less efficient because concentrated ownership creates the incentive for controlling shareholders to expropriate wealth from the minority shareholders (Fama and Jensen, 1983; Morck et al., 1988; Shleifer and Vishny 1997). Controlling shareholder members usually hold important positions on both the management team and the board of directors. In such cases, firms may have inferior corporate governance because of ineffective monitoring by the board. Therefore, conservative accounting helps address the entrenchment effect. Asymmetric verification standards imply that the book value at any point in time understates the value of resources available for interim distributions (Watts 2003a). Tying compensation to changes in book value, or earnings, along with conservative reporting effectively penalizes controlling shareholders for their value-reducing actions and defers their compensation until the benefits are realized. This reduces the controlling shareholders' ability to overstate cumulative changes in firm value and avoids the deadweight costs associated with controlling shareholders attempting to transfer wealth rather than optimally managing the firm.

A competing view is the alignment effect, which is based on the argument that family firms have incentives to report earnings in good faith and thus earnings are of higher quality. The alignment effect implies that concentrated ownership creates greater monitoring (Demsetz and Lehn, 1985; Shleifer and Vishny, 1997), suggesting that controlling shareholders might monitor firms more effectively. The reason is that

because of controlling shareholders' long-term and sustainable presence in the firm and their intention to preserve the family name, controlling shareholders have a greater stake in the firm than nonfamily professional executives. Hence, controlling shareholders are more likely to forgo short-term benefits from managing earnings because of the incentives to pass on their business to future generations and to protect the family's reputation. Accordingly, the alignment effect implies that controlling shareholders are less likely to engage in opportunistic behavior in reporting accounting earnings because it potentially could damage the family's reputation and wealth, and the long-term firm performance.

The literature has considered the possibility that high ownership stakes signify greater managerial entrenchment. In other words, it is possible that shareholders with a greater ownership stake are less likely to be disciplined when they engage in actions that serve their own interest but conflict with minority shareholders' interests. In that case, the relationship between managerial ownership and the alignment of managerial interests is more ambiguous. The relation between controlling shareholders and accounting conservatism might potentially fit in the realm of the entrenchment effect, whereby family members expropriate wealth from other shareholders by managing accounting earnings (Jensen and Meckling, 1976). As a result, the relationship between controlling shareholders and minority shareholders should be negatively related to family ownership. This study predicts that when the severity of entrenchment effect increases, controlling shareholders (including founding family (*FF*) and family (*FAM*) firms) are likely to provide managers with greater opportunity to use less conservative accounting. Thus, *FF* and *FAM* member ownerships are expected to be negatively associated with accounting conservatism.

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In addition, this study also examines the relation between accounting conservatism and politically connected firms which are controlled by controlling shareholders. As a result of cronyism, without significant pressure from public investors for companies to report losses in a timely fashion, companies which are related to politically connected firms often prevent or delay a company's failure by allowing or encouraging it to record losses immediately. Agrawal and Knowber (2001) and Faccio (2004) find that political connections help firms to secure favorable regulatory or tax conditions. Politically connected firms provide incentives for their controlling shareholders to overstate the value they create by overstating current earnings and the expectation of future cash flows, which are also related to the entrenchment effect. Therefore, the controlling shareholders in politically connected firms may intend to transfer wealth to themselves rather than fulfill their primary function: managing the firm efficiently and creating value for minority shareholders. It means that politically connected firms which are controlled by controlling shareholders are less likely to be disciplined when they engaged in actions that serve their own interests but conflict with minority shareholders' interests. The relationship between politically connected firms which are controlled by controlling shareholders and minority shareholders should be an inverse relationship. Thus, this study predicts that when the severity of cronyism and the entrenchment effect increases, politically connected firms are negatively associated with accounting conservatism, *ceteris paribus*.

The literature on family business is wide-ranging and it is no distinguishes the exact definition founding family and family firms[3]. This study distinguishes founding family in which there is a founder who takes responsibility for the firm's early growth and development, with family firm in which there is a family who did not take responsibility for the firm's early growth and development. This study defines and characterizes controlling shareholder characteristics as follows:

a) Founding family (hereafter "*FF*") firms are established by a founder, who takes responsibility for the firm's early growth and development. At least 10% of the firm's equity is owned by the founder or by founding family members by blood or marriage.
b) Family (hereafter "*FAM*") firms are firms owned by a family who did not take responsibility for the firm's early growth and development. Firms in this category refer to non-founding family firms that have at least 10% of the firm's equity is owned by members of the new family by blood or marriage.

This study utilizes several measures. The first measure of ownership is the percentage of the firm's outstanding shares owned by *FF* or *FAM* members. Membership of the family is either by blood or marriage. Members of the family own at least 10% of the firm's equity, individually or as a group. Second, this study divides the ownership level into 10%-20%, more than 20%-50%, and more than 50%. Third, this study measures the CEO attributes of *FF* and *FAM* firms. CEOs are classified as founders, descendants, or hired outsiders (professional CEOs). Lastly, this study

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[3] Anderson and Reeb (2003) define founding family in U.S. as fractional equity ownership of the founder family and/or the presence of family members serving on the board of directors. Ang et al. (2000) define that family firm in U.S. as a single family control more than 50% of the firm's shares. Claessens et al. (2002) note that family firm in 9 East Asian Countries as family group that control more than 5% of the company's votes. Faccio and Lang (2002) note that family firm in 13 Western European countires as a family or an individual or unlisted firm on stock exchange is considered as the ultimate owner (greater than 20% of either cash flow or control rights). Barth et al. (2005) define that family firm in Norway as one person or one family control more than 33%.

measures the politically connected firms using dummy variable. Politically connected (hereafter "*POL*") firms are defined as founding family or family firms where one of the company's major shareholders or top directors is a member of parliament or a minister or the head of state (Faccio, 2006). This study also includes government or state owned firms as politically connected firms.

This study's primary measure of conservatism is the asymmetric timeliness of earnings which reflect bad news (e.g., unrealized losses) more quickly than good news (e.g., unrealized gains) (Basu, 1997). The sample covers 1,733 firm-years over the period 2000-2006. The sample is entirely based on Thai listed company data from the Stock Exchange of Thailand ("SET").

This study finds a negative association between asymmetric timeliness of earnings reports and ownership of firms by *FAM* members. This study does not find any relationship between good news timeliness and *FAM* firm ownership. Thus, as *FAM* member ownership increases, earnings reports become less conservatism, consistent with the entrenchment effect. In contrast, this study documents a positive association between asymmetric timeliness of earnings reports and ownership of firms by *FF* members. However, this study does not find any relationship between good news timeliness and *FF* firm ownership. Thus, as the level of ownership of a firm by *FF* members increases, earnings reports become more conservatism. This study also includes corporate governance and firm characteristics as control variables. The corporate governance control variables include duality, board size, independent directors, and big four audit firms. Firm characteristic control variables include leverage, institutional ownership, market value, litigation risk, and market-to-book ratio.

In addition, this study also divides percentage of ownership into 10%-20%, more than 20%-50% and more than 50%. The results show that in *FAM* firms, where *FAM* members own between 10%-20% and more than 20%-50% of the firm, earnings report become less conservatism. In addition, this study finds that in *FF* firms, where the *FF* members own more than 20%-50% and more than 50% of the firm, earnings reports become more conservatism and finds that in *FF* firms where *FF* members own between 10%-20% of the firm, earnings reports become less conservatism.

For CEO characteristics, founder, descendent, and hired outsider CEOs in *FF* firms are associated with more conservative earnings reports. In FAM firms, this study finds that only descendant CEOs are associated with less conservative earnings reports.

This study also investigates politically connected firms and accounting conservatism. This study finds that in politically connected *FF* firms, earnings reports become less conservatism. Politically connected firms may sometimes be able to have influence or power of preferment to members of the government and/or regulatory bodies to avoid or minimize scrutiny or compliance with relevant laws. Generally, politically connected firms typically derive gain from their connections over and above the power they make. The nature of their power and gains may create additional incentives to expropriate, or at least to hide information from the firm's minority shareholders. The result indicates that no relationship is found between good and bad news timeliness in politically connected *FAM* firms.

The evidence in this study connects accounting conservatism and controlling shareholder (including *FF* and *FAM* firms), which is important in the light of recent literature that has primarily focused on the accounting conservatism arising out of debt contracting, corporate governance, and international accounting. This study finds complement in concurrent research by LaFond and Roychowdhury (2008), who examine the effect of managerial ownership on financial reporting conservatism. LaFond and Ryochowdhury (2008) find that, as managerial ownership declines, earnings reports become less timely in recognizing good new and more asymmetrically timely in recognizing bad news.

This study differs from LaFond and Roychowdhury (2008), in three important ways. First, there are important differences in US GAAP and Thai GAAP. In general, Thai GAAP follows International Financial Reporting Standards ("IFRS"). IFRS allows more variation in conservatism across firms. For example, it permits upward revaluations of assets and capitalization of property, plant, and equipment and capitalization of certain internally-generated intangibles (e.g. development costs) whereas US GAAP prohibits such upward revaluation or capitalization of intangibles (Ahmed and Duellman, 2007). Furthermore, US firm are subject to considerably higher litigation risk than Thai firms. Second, LaFond and Roychowdhury (2008), focus on examining CEO ownership, while this study examines accounting conservatism in *FF* and *FAM* firms. Third, Thailand data are interesting because corporate governance in Thailand is weak relative to the US (Fan and Wong, 2002). This affords controlling shareholders the opportunity to expropriate minority shareholders' wealth through excessive compensation schemes and related party transactions.

*1.2 MOTIVATION*

Most listed companies in East Asia have ownership concentrated in the hands of a few large shareholders or are affiliated with a business group which is controlled by one family (Fan and Wong, 2002). Like that of other East Asian countries, ownership structure in Thailand also tends to be highly concentrated. The average percentage of common shares owned in Thailand in 1993 by the three largest shareholders is around 47 percent (La Porta et al., 1998). Khanthavit et al. (2003) study the corporate controlling shareholders in Thai listed firms and find that the average percentage of common shares owned by families in 1996 is approximately 51.14 percent, compared to 45.65 percent in 2000. This implies that the average percentage of common shares owned by families is still relatively high even after the financial crisis in 1997. In addition, family controlled firms are often politically well-connected (Faccio, 2006). Faccio (2006) finds that firms with well-connected political connections tend to be widespread. She finds at least one connected firm in 35 of the 47 countries. Fisman (2001) conducts an event study on the stock price effects of the new announcement of Suharto's (former Indonesian President) illness and finds that his illness causes the drop in value of politically connected firms.

While a number of prior studies examine the relation between ownership structure and firm performance[4], ownership structure and corporate governance (Kang, 1998; Yermack, 1996; Mishra et. al., 2001; Anderson and Reeb, 2004), ownership structure and earnings management (Giroux, 2004; Warfield et al., 1995; Gabrielsen et al., 2002; Wang, 2006; Jaggi and Leung, 2007), ownership structure and earnings quality (Fan

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[4] See Shleifer and Vishny, 1997; Morck et al., 1988; Holderness and Sheehan, 1998; Demsetz, 1983; Demsetz and Lehn, 1985; Anderson and Reeb, 2003; Maury, 2006.

and Wong, 2002; Wang, 2006; Ali et al., 2007) and politically connected family firms and firm performance (Fisman, 2001; Imai, 2006; Bertrand et al., 2005; Fan et al., 2007; Faccio, 2006). To my knowledge, no prior studies have examined the relationship between accounting conservatism and controlling shareholder characteristics. Moreover, this study distinguishes between *FF* and *FAM* firms. Is there a difference in accounting conservatism between *FF* and *FAM* firms?

### *1.3 RESEARCH OBJECTIVE*

The objective of this study is to examine the relationship between accounting conservatism and controlling shareholder characteristics. The findings will provide greater knowledge and understanding of the effects of controlling shareholder characteristics on accounting conservatism. To achieve this outcome, this study has four objectives:

- To generate and test new predictions by considering the timeliness and accounting conservatism of good and bad news reported by Thai listed firms. There is a lack of consistency in prior research with respect to accounting conservatism. Ball et al. (2003) compare four East Asian countries (Hong Kong, Malaysia, Singapore and Thailand) during the period 1984-1996. They find that earnings reports in Thailand have no accounting conservatism when recognizing bad news as compared to good news. On the other hand, Bushman and Piotroski (2006), study 38 countries (including Thailand) during the period 1992-2001. They find that earnings reports in Thailand have accounting conservatism in recognizing bad news relative to good news.
- To deeply understand the relationship between accounting conservatism and Thai listed firms whose controlling shareholder are *FF* members.

- To deeply understand the relationship between accounting conservatism and Thai listed firms whose controlling shareholder are *FAM* members.
- To deeply understand the relationship between accounting conservatism and controlling shareholders (including *FF* and *FAM* firms) who are politically connected in Thai listed firms.

*1.4 CONTRIBUTIONS*

This study provides a better understanding of the controlling shareholder characteristics (for *FF* and *FAM* firms) and examines the impact of conservative reporting and the gain through linking conservatism literature to the theory of controlling shareholder characteristics by using firm-level data for listed companies in the Stock Exchange of Thailand ("SET") from 2000-2006. This information should be of interest to various parties including local and foreign investors, financial practitioners, standard setters, regulators and policy makers in the Thai capital market, and academics because the relationship between accounting conservatism and *FF* and *FAM* firms understates the current period accounting numbers and will eventually lead to overstatement of earnings in future period which causes an understatement of future expenses.

This study uses a dataset of Thailand firms because a Thai corporate ownership structure generally reflects an institutional setting that is similar to that of other East Asian settings, where frequent heavy concentrations of shareholding are prevalent and family firms are generally politically connected. The results of this study could be generalized to other capital markets in East Asia.

*1.5 STRUCTURE OF THE DISSERTATION*

The dissertation is divided into seven chapters. Chapter I introduces the research and its objectives. Chapter II discusses ownership concentration, politically connected firms, and accounting standards in Thailand. Chapter III presents a literature review. Chapter IV presents theory and hypotheses development. Chapter V presents the research design, providing detail about sample selection, data, model specifications, and variable measurement. Empirical findings, conclusions and limitations are presented in the last two chapters.