# CHAPTER III

# LITERATURE REVIEW

## *3.1 OWNERSHIP STRUCTURE AND FIRM PERFORMANCE*

The connection between ownership structure and performance has been the subject of an important and ongoing debate in the literature. The debate goes back to Berle and Means (1932) who are among the first to consider the relationship between a firm's ownership structure and its performance (Welch, 2003; Demsetz and Villalonga, 2001). They assert that as the diffuseness of ownership increases, shareholders become powerless to control professional managers. Further, they argue that given that the interests of management and shareholders are not generally aligned, corporate resources are not used efficiently in maximizing corporate profit. Therefore, Berle and Means (1932) suggest that an inverse correlation should be observed between the diffuseness of shareholder ownership and firm performance.

Demsetz (1983) argues that the ownership structure of a corporation should be thought of as an endogenous outcome of decisions that reflects the influence of shareholders and of trading on the market for shares. When owners of a privately held company decide to sell shares, and when shareholders of a publicly held corporation agree to a new secondary distribution, they are, in effect, deciding to alter the ownership structure of their firms and, with high probability, to make that structure more diffuse. Subsequent trading of shares will reflect the desire of potential and existing owners to change their ownership stakes in the firm. In the case of a corporate takeover, those who would be owners have a direct and dominating influence on the

firm's ownership structure. In these ways, a firm's ownership structure reflects decisions made by those who own or who would own shares. The ownership structure that emerges, whether concentrated or diffuse, ought to be influenced by the profit-maximizing interest of shareholders, as a result, there should be no systematic relation between variations in ownership structure and variation in firm performance.

Jensen and Meckling (1976) argue that firm value is positively correlated with the level of managerial ownership because of reduced agency cost and increased alignment of interest between managers and shareholders. Demsetz and Lehn (1985) find evidence that controlling shareholders have a strong incentive to diminish agency problems and maximize firm value. In other words, concentrated ownership aligns the interest of controlling shareholders with those of non-controlling shareholders.

Smith and Amoako-Adu (1999) examine the immediate and long-term impacts on financial performance of 124 management successions within Canadian family controlled firms listed on the Toronto Stock Exchange between 1962 and 1996. The firms in question that underwent a succession in which a family member, non-family insider, or an outsider was appointed to the position of president and/or CEO. When family successors are appointed, the stock prices usually decline by 3.2% during the 3-day (-1 to +1) event window, whereas there are no significant decreases when either non-family insiders or outsiders are appointed. They argue that shareholders react negatively to the appointment of a family member because of greater uncertainty over the management quality than the appointment of non-family insiders and outside successors.

Anderson and Reeb (2003) investigate the relation between *FF* ownership and firms' performance (using Tobin's *Q* values and return on assets). They find that *FF* ownership is both prevalent and substantial; families are presented in one-third of the S&P 500 and accounted for 18 percent of outstanding equity. Contrary to their conjecture, they find family firms have higher Tobin's *Q* values and higher return on assets than comparable non-family firms. The result supports the view that family ownership reduces the classical agency problem between managers and shareholders. Maury (2006) also investigates how family-controlled firms performed in relation to firms with non-family controlling shareholders in 1998 in countries in Western Europe, including Austria, Belgium, Finland, France, Germany, Ireland, Italy, Norway, Portugal, Spain, Sweden, Switzerland, and the UK. Maury (2006) finds that active family control, in which the family holds at least one of the top two officer positions (CEO, Honorary Chairman, Chairman, or Vice Chairman), is associated with higher profitability compared to non-family firms.

In addition, Anderson and Reeb (2003) perform additional analysis and find that when a family members serves as CEO, performance is better than with outside CEOs. Villalonga and Amit (2004) find that a higher valuation of family firms arises when the founder serves as CEO or as Chairman of the board with a hired CEO.

On the other hand, Morck et al. (1998) examine the relation between managerial ownership and performance in 1980 of a cross-section of 371 Fortune 500 firms in the US. They estimate a piecewise linear regression of performance (using Tobin's *Q*) and managerial ownership. This provides evidence of a non-monotonic relationship. The estimated piecewise regression is positive for management holdings of shares between 0% and 5% of outstanding shares, negative for management holdings between 5% and

25%, and positive once more for management holding greater than 25%. In addition, Holderness and Sheehan (1998) find a tendency for firms majority-controlled by a family to have lower performance than diffusely held firms.

### *3.2 OWNERSHIP STRUCTURE AND CORPORATE GOVERNANCE*

The corporate governance literature suggests that other mechanisms can be used to alleviate managerial opportunism. Fama and Jensen (1983) suggest that family relationships between managers and owners should reduce agency costs because of the multidimensional, long-term nature of those relationships which also improves monitoring of decision agents (managers). DeAngelo and DeAngelo (1985) also suggest that family involvement serves to monitor and discipline managers. Kang's (1998) field research suggests that *FF* members are active monitors of their managers. He suggests that the information flow between managers and family members acts as a control mechanism, where managers make decisions with the understanding that they have to eventually justify them to family owners in face-to-face conversations. Because *FF* control is unique, the level of outside representation on the board might not affect the relation between *FF* control and firm value.

Yermack (1996) examines the relation between board size and firm value. He finds that firms with small board sizes have higher stock market values. Using a sample of large US corporations, he finds an inverse relation between firm value and board size. Yermack suggests that small boards are more common in companies controlled by founding families. It is possible that *FF* companies have been more effective because they generally have smaller boards. Board member interrelation can be more easily managed in smaller boards. Furthermore, smaller boards can help *FF* owners make decisions more quickly.

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Mishra et al. (2001) examine the influence of *FF* control on firm value and corporate governance in non-financial Norwegian firms. They find that small board size might be a superior corporate governance mechanism for firms managed by a founding family CEO. Smaller boards can help founding family CEOs to make decision more quickly (times) and to be more flexible. A small board might also help to manage the interrelationship between board members more effectively. In addition, they also found that outside director representation (board independence) does not improve corporate governance in *FF* controlled firms. Family firms' value can create a commitment to long-term value creation. Once the commitment is in place, the need for outside board monitoring is diminished and the inside directors who know the company and the marketplace may be more valuable to family firms.

Anderson and Reeb (2004) examine 403 firms of S&P 500 and find that board independence bears a significant and positive relation to performance in firms with founding-family ownership. They note that independent directors act to prevent family misappropriation of firm resources, thereby resulting in better firm performance. In other words, the observed relation could simply be that families themselves place independent directors on the board to act as advocates of firm health and corporate viability.

*3.3 OWNERSHIP STRUCTURE AND EARNINGS MANAGEMENT*

Giroux (2004) documents that the objective of accounting information is to display financial and economic reality. In this continuum, earnings management includes the whole spectrum from conservative accounting, moderate accounting, aggressive accounting, and fraud. Thus, management takes a relative position on accounting

issues reflected in its reports. It is natural to expect that managers will choose accounting policies to maximize their own utility and the market value of the firm. Besides the financial motivation of earnings management to increase firm value, there are two contrasting complementary ways to think about earnings management. First, earnings management can be seen as opportunistic behavior by managers to maximize their utility. Second, earnings management can be seen from an efficient contracting perspective. In the banking environment, both of the contractual earnings management perspectives arise from the moral hazard problem between borrower and lender. From the lender's point of view, conservative reporting is certainly a better alternative than fraud.

Warfield et al. (1995) examine US data and find an inverse relationship between managerial ownership and absolute abnormal accruals. They note that it is possible that the absolute abnormal accrual measure captures the manifestation of the manager-owner incentive problem. Gabrielsen et al. (2002) examine the relationship between managerial ownership and absolute abnormal accruals in a sample of Danish firms between 1990 and 1996. They find that managerial ownership is negatively associated with absolute abnormal accruals among regulated industries (such as transportation firms and public utilities), a result consistent with that of Warfield et al. (1995).

Wang (2006) investigates the relationship between *FF* ownership and absolute value of abnormal accrual (earnings before extraordinary items minus operating cash flows) by using data from S&P 500 firms during the period 1994-2002. He finds that *FF* ownership is negatively associated with absolute abnormal accruals, or that *FF* firms report a lower level of abnormal accruals, a finding consistent with the alignment

effect of family ownership on the supply of earnings quality, or alternatively, the entrenchment effect on the demand for earnings quality.

Jaggi and Leung (2007) examine whether the establishment of audit committees by Hong Kong firms would constrain earnings management, especially in firms with family-dominated corporate boards during the period of 1999-2000. Their results show that audit committees play a significant role in constraining earnings management even in a business environment of higher ownership concentration. The effectiveness of audit committees is, however, significantly reduced when family members are present on corporate boards, especially when family members dominate the corporate board.

### *3.4 OWNERSHIP STRUCTURE AND EARNINGS QUALITY*

Fan and Wong (2002) explore the relationship between earnings informativeness and the ownership structure of 977 companies in seven East Asian economies: Hong Kong, Indonesia, Malaysia, Singapore, South Korea, Taiwan, and Thailand using data from PACAP (electronic database is commercially distributed by University of Rhode Island) during 1991-1995. They find a negative relationship between return and the controlling ownership of the largest owner. The explanation is based on the controlling owners' entrenchment. The earnings credibility is weakened because minority shareholders anticipate that the ownership structure gives the controlling owners both the ability and incentive to manipulate earnings for outright expropriation or to report uninformative earnings to avoid detection of their expropriation activities.

Wang (2006) investigates the relationship between *FF* ownership and earnings quality using data from S&P 500 firms during the period 1994-2002. Wang (2006) suggests that financial reporting is of higher quality when firms have stronger corporate governance mechanisms and when there is greater demand for quality financial reporting. He provides two competing theories of the effect of *FF* ownership on the demand and supply of earnings quality: the entrenchment effect and the alignment effect. The empirical results show that, on average, *FF* ownership is associated with higher earnings quality.

Ali et al. (2007), in a sample of S&P 500 firms between 1998 and 2002, investigate the relationship between reported earnings for family firms as compared to non-family firms. They measure earnings quality by the level of discretionary accruals in earnings, the ability of earnings' components to predict future cash flows, and an earnings response coefficient. They find that reported earnings are of better quality for family firms as compared to non-family firms.

### *3.5 POLITICALLY CONNECTED FIRMS AND FIRM PERFORMANCE*

Fisman (2001) explores the returns on shares of politically dependent firms (politically dependent firms with respect to Suharto who was formerly President of Indonesia) and less-dependent firms which are listed in Jakarta Stock Exchange between 1995 and 1997. From 1995-1997, the Indonesian financial market was occasionally hit by rumors about Suharto's health. This study conducts an event study on the stock price effects of new announcements of Suharto's illness and analyzes the value drops in the firms connected to Suharto. The result shows that the proportion of these firms' share value attributed to a Suharto connection is very large.

Bertrand et al. (2005) investigate whether CEOs of publicly traded companies who have, through their educational and professional backgrounds, tied to the political leadership are willing to bestow "economic favors" on politicians to help their re-election changes in France over the period 1989 to 2002. They find that firms managed by such connected CEOs have lower rates of return on assets, than those managed by non-connected CEOs. In other words, the net benefits from political connection in France may not be significantly positive enough to give connected firms an economic advantage over non-connected firms. More directly, they also find that connected CEOs create more jobs in election years than in years further away from an election. Similarly, connected CEOs create more jobs in politically less stable areas, and that this is especially so around election years.

Imai (2006) investigates the relationship participation of family members and the profitability of family businesses in a sample of 398 unconnected firms and 79 politically connected Thai firms between 2001 and 2005. He finds that the political participation of family members is positively associated with the profitability of family businesses which are connected to a cabinet member.

Fan et al. (2007) investigate firm performance for firms with politically connected CEOs and for firms without politically connected CEOs in a sample of 790 newly partially privatized firms in China. They find that firms with politically connected CEOs underperformed compared to firms without politically connected CEOs. They suggest that politically connected CEOs show a low degree of professionalism, as few CEOs have relevant professional backgrounds.

Faccio (2006) studies politically connected family firms over 20,000 listed companies from 47 countries. She finds political connections to be relatively widespread, with at least one connected firm in 35 of the 47 countries. Overall, 541 firms are politically connected family firms, representing almost 8% of the world's market capitalization. She conducts an event study around the time of the announcements of directors or large shareholders entering politics, and finds a significant increase in corporate value, when those involved in business enter politics.

### *3.6 PREVIOUS RESEARCH ON ACCOUNTING CONSERVATISM*

There is an abundance of literature focusing on the role of conservatism in accounting. The definition of conservatism is given in Appendix C. However, a review of the extensive literature on accounting conservatism is outside the scope of this study[10]. This study will focus on the papers that are central to the measurement of conservatism, including Basu (1997), Givoly and Hyan (2000), Givoly et al. (2007), and Rowchowdhury and Watts (2007).

Basu (1997) introduced a model that measures conservatism based on the differential reflection of good news and bad new in earnings. The primary measure of conservatism in the Basu model is the coefficient $\beta_3$ in the regression:

$$EPS = \beta_0 + \beta_1 RD_{it} + \beta_2 R_{it} + \beta_3 R_{it}*RD_{it} + \varepsilon_{it} \quad (1)$$

[10] For additional information, Watts (2003a) provides an excellent review of the role of conservatism in accounting while Watts (2003b) summarized the findings of conservatism research.

where *EPS* is the earnings per share before extraordinary items of firm *i* in fiscal year *t* divided by beginning of period price per share at the beginning of the fiscal year, $R_{it}$ is the return of firm *i* over the 12 months beginning four months prior to the end of fiscal year *t*, and $RD_{it}$ is a dummy variable set equal to 1 if $R_{it}$ is negative and 0 otherwise.

The Basu (1997) measure gains wide appeal as the interpretation of the model is quite intuitive. The greater the coefficient $\beta_3$, the faster losses are recognized in earnings over gain. Thus, firms that are more conservative will have greater asymmetric verifiability between gains and losses.

Reasonably, Basu (1997) assumes that positive stock return in a period generally reflects net assets gains and negative stock returns reflect net assets losses. If losses are subject to a lesser degree of verification than gains, Basu argues earnings will reflect net assets losses more quickly (times) than net assets gains. The consequence is that stock returns and earnings will tend to reflect net assets losses in the same period, but stock returns will reflect net asset gains in an earlier period than earnings. In particular, Basu predicts that negative stock returns are more likely than positive stock returns to be fully reflected in earnings of the period in which those returns occur. Basu explains earnings conservatism as capturing accountants' tendency to require a higher degree of verification for recognizing good news than bad news in financial statements. For this reason, earnings incorporate bad new more quickly (times) than good news. Using a reverse regression, he studies for the first time asymmetry and timeliness in incorporating good and bad news in accounting earnings. Firms' stock returns listed on CRSP NYSE/AMEX monthly files are used to measure news. Basu finds that the

association of earnings to negative returns is two-to-six times that of earnings to positive returns. That is, conservatism results in asymmetric timeliness of earnings. He attributes the asymmetry between good and bad news recognition in earnings to the legal liability exposure faced by auditors and managers for tardy disclosure of bad news. Conservatism reduces auditors' and managers' liabilities exposure and they are thus expected to have increased the asymmetric timeliness of earnings in response to increases in their legal liability exposure.

Givoly and Hyan (2000) adopt Basu's (1997) model and test conservatism in US firms during the years 1950 to 1998. They provide evidence of more timely recognition of bad news in relation to good news. The results indicate an increase in the degree of conservatism over time. In addition, they also argue that reported profitability has declined over the research period, but this decline is not accompanied by a corresponding decline in cash flows. Moreover, earnings distribution has become more dispersed and skewed over time relative to cash flows.

Recently, the Basu measure has come under heavy criticism. First, Givoly et al. (2007) point out that the Basu measure is negatively correlated with other conservatism measures such as market-to-book ratio. Second, the results of the asymmetric timeliness measure are inconsistent across different-sized portfolios. For instance, Watts and Zimmerman (1986) argue that there should be a positive relation between firm size and conservatism, but the coefficient of differential timeliness is larger for small firms (Givoly et al., 2007).

Rowchowdhury and Watts (2007) respond to these criticisms by demonstrating that the sign and magnitude of the asymmetric timeliness coefficient varies based on the measurement period of earnings and returns. Furthermore, when asymmetric verifiability is measured historically over several years, market-to-book and asymmetric verifiability are positively related. Therefore, firms with a high market-to-book ratio experiences greater historical asymmetric verifiability.

Ahmed and Duellman (2007) investigate accounting conservatism and board of director characteristics. Their sample consists of 306 firms out of the S&P 500 over the fiscal years 1999-2001. They utilize three conservatism measures: an accrual-based measure, a market-based measure, and a measure of asymmetric timeliness of earnings following Roychowdhury and Watts (2007). They find that the percentage of inside directors is negatively related to conservatism and the percentage of outside directors' is positively related to conservatism.

LaFond and Roychowdhury (2008), who examine the effect of managerial ownership on financial reporting conservatism. They find that, as managerial ownership declines, earnings reports become less timely in recognizing good new and more asymmetrically timely in recognizing bad news.